UK CAPITAL VIEW: Summer 2019

Key themes:

- **Geopolitics:** Economic and political uncertainty is not just a UK-centric trend **(**Page 3)
- **Industrial:** Implementation of technology by tenants is having a positive effect on lease lengths **(**Page 4)
- **High Street Retail:** Focus on assets that have had their rents re-based over the last 12-18 months (Page 5)
- **South Bank Office:** Take advantage of the revitalisation across London's third core office market (Page 6)
- **South East Office:** Which office markets can expect to see interest from cross-border capital (Page 7)
- **Healthcare:** Strong long-term demographic trends helping drive investment demand (Page 8)
- **Residential Investments:** Sector to reach £146bn by 2025 (Page 9)

Knight Frank

The State of Play

- Investors continue to respond to structural changes across the real estate sectors and a lower interest rate, lower return environment. Driving income growth remains the focus for investors.
- UK GDP growth accelerated to 1.8% y-y in Q1 2019. The economy is forecast to continue to enjoy steadily accelerating growth over the rest of the year and into 2020. This is compared to parts of mainland Europe, which are expected to see economic growth ease after a stronger period of economic expansion.
- While Brexit has contributed to increased levels of economic uncertainty in the UK, it is important to realise that this current state of ambiguity is not just a UK centric problem and economic uncertainty remains high in many global economies.
- Structural changes continue to affect investment returns on the upside and downside across different sectors. On the upside, technology is helping support longer lease lengths in the industrial sector, while long-term demographic trends are helping shape the growing healthcare and residential investment markets. On the downside, weak occupier fundamental continue to hinder investment sentiment and subsequent performance in the retail sector.
- We expect investors to look towards local market fundamentals, rather than country level economics. Income remains the focus. This should see investors venture into neighbouring or regional markets which are benefitting from strong local occupier market fundamentals. This strategy will apply to all asset classes, as the performance of the strongest markets continues to diverge from the performance of the weaker markets.

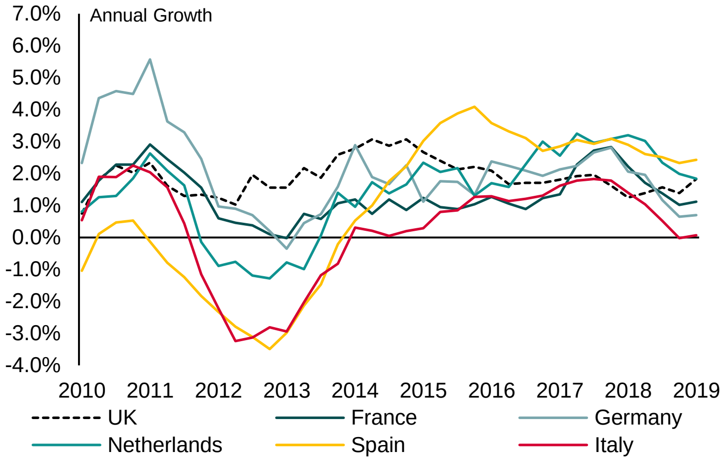
UK CAPITAL VIEW:

SUMMER 2019

- UK GDP growth accelerated to 1.8% y-y in Q1 2019. The economy is forecast to continue to enjoy steadily accelerating growth over the rest of the year and into 2020. This is compared to parts of mainland Europe, which are expected to see economic growth ease after a stronger period of economic expansion.
- Brexit related uncertainty and weaker investor sentiment in the retail sector contributed to UK all property investment volumes declining by -22% y-y in Q1 2019. However, this is a softer reduction than the decline in transaction activity globally (-24%) and for Europe (-32%). Economic and political uncertainty is not just a UK-centric Brexit related issue, but also a global theme.
- While overall UK transaction volumes were down by historical standards, investment activity in the industrial and leisure sectors outperformed their first quarter long-term averages in Q1 2019.
- There is contrasting investment performance across the UK property sectors. The Industrial sector continues to outperform the wider market with an annual total return of 13.7%, followed by Healthcare (9.3%) and Hotels (7.9%). Supermarkets remain in positive territory, but other retail is seeing negative annual returns.

UK GDP growth is improving compared to other European economies

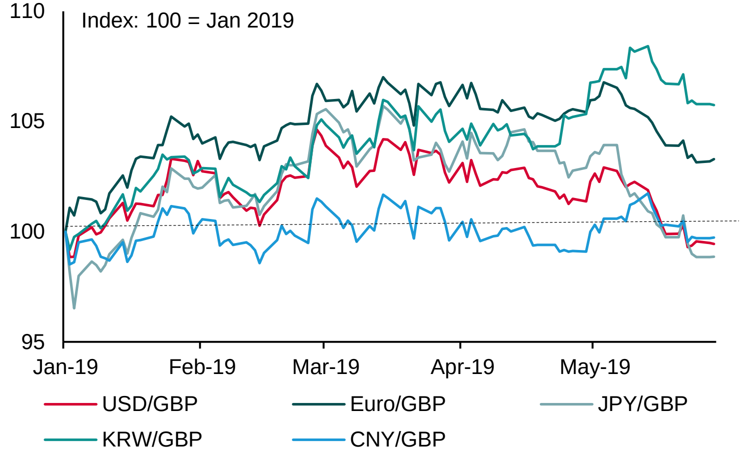
Figure 1: Annual GDP growth



Source: Macrobond, Knight Frank

The Pound has appreciated against the Euro & KRW, but volatility persists

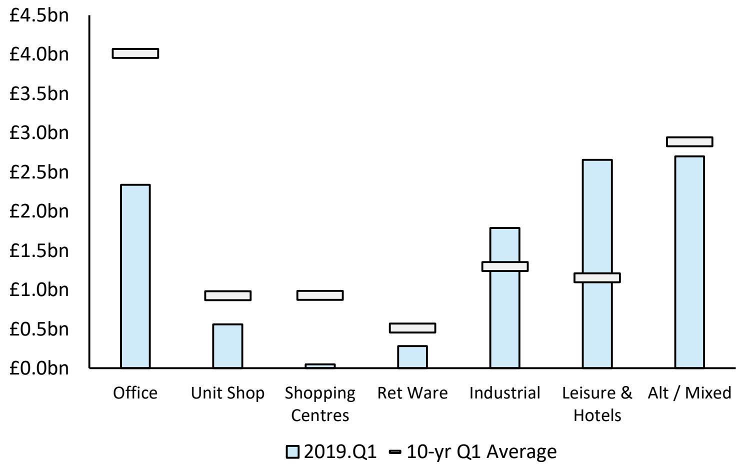
Figure 2: GBP currency index



Source: Bank of England, Knight Frank

Industrial & specialist services investment demand is healthy

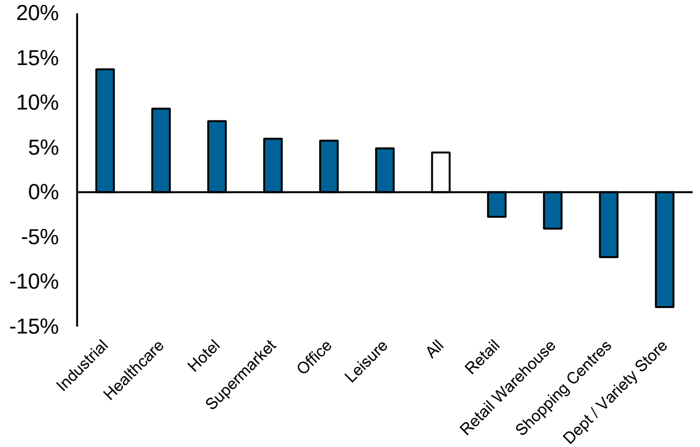
Figure 3: Q1 2019 UK Property Transaction Volumes by Sector



Source: PropertyData, Knight Frank

Reflecting the contrast in performance across UK property sectors

Figure 4: UK Annual Total Returns, Q1 2019



Source: MSCI, Knight Frank

UK CAPITAL VIEW:

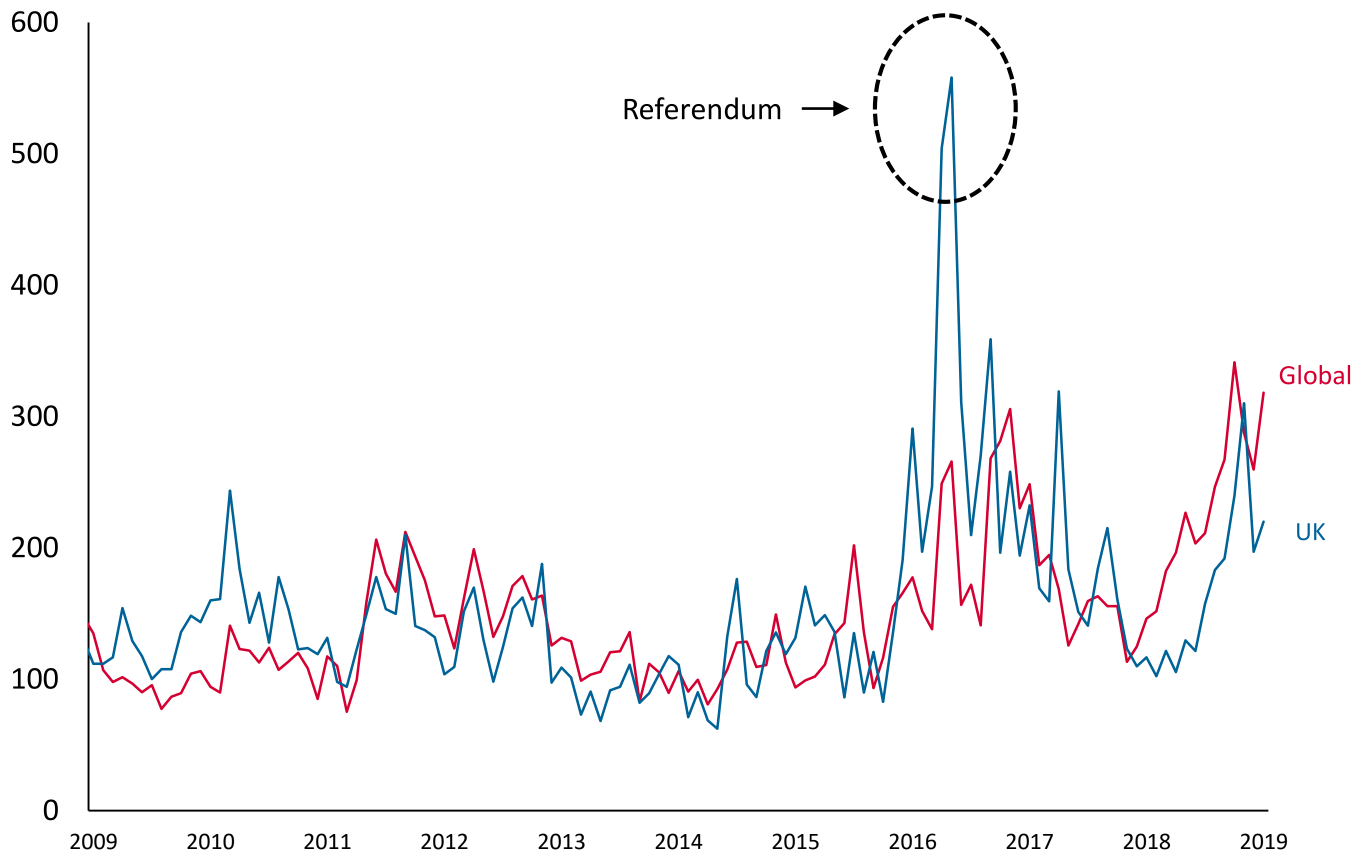
GEOPOLITICS

Economic and political uncertainty is not just a UK-centric trend

- **While Brexit has contributed to increased levels of economic uncertainty in the UK, it is important to realise that this current state of ambiguity is not just a UK centric problem and economic uncertainty remains high in many global economies.**
- Global economic uncertainty is high on the back of the US:China trade war and European politics. This unpredictable global political environment coupled with many mature global economies reaching an extended late cycle is creating increased volatility across global financial markets. Investment activity has been slower during the start of 2019 as a result, and investors are expected to remain cautious while volatility remains elevated.
- The UK is not immune to the effects of global uncertainty, however, it does still maintain its status as a global safe heaven with high levels of transparency, liquidity and governance. These attributes have and will continue to underpin investor and tenant demand for real estate in the UK.
- Investors need to look beyond the rhetoric and focus on key growth markets where strong demographic trends are spurring wealth creation and helping drive underlying occupier market fundamentals.
- Key considerations for investors also include whether new and existing infrastructure is supportive of the building use and subsequent demand stemming from both tenants and prospective investors.

Global policy uncertainty is outweighing UK based uncertainty

Figure 5: Economic policy uncertainty rating



Source: Policy Uncertainty, Knight Frank

UK CAPITAL VIEW:

INDUSTRIAL

Implementation of technology by tenants is having a positive effect on lease lengths

- **The industrial & logistics sector is benefitting from the structural and technological tailwinds changing the real estate market. This has led to strong rental growth due to new avenues of tenant demand, and yield re-rating as investor perception of the sector changes.**
- Secure long-term income is one of the primary attributes that investors (especially liability matching investors) are seeking. Technology is helping industrial assets provide this long-term income through longer lease lengths as tenants look to lock in fixed costs and improve the efficiency of their supply chains. Average new lease lengths for industrial tenants in the UK have gone from 4.6 years in 2011 to 7.3 years in 2018.
- Industrial floor space in general is vastly different today to what it was 10-years ago, both in use, quality and value. The change in industrial floor space does not just apply to the global manufacturing or e-commerce businesses, but also many small to medium sized domestic businesses that are also becoming more innovative in the way they manufacture their products or run their businesses.
- Such is the extent of the technological input into the modern warehouse that, in our estimation, the fit-out cost is two to four times the construction cost of the base building. It is not uncommon for an e-commerce provider to spend tens to hundreds of millions in fitting out their operating space with the latest technology as they push for increased productivity and optimising fixed costs in their supply chain.
- These high fit-out costs mean that expected lease lengths of the mega distributions centres are extending, providing further scope for yield re-rating for investors.
- The longer lease terms and subsequent increased WAULT’s (Weighted Average Unexpired Lease Term) of industrial assets should continue to support the yield re-rating of the sector. Investor demand is expected to remain strong as investors continue to be attracted to the secure income profile of long-leased industrial assets and the structural tailwinds fuelling income growth in the sector.

Industrial lease lengths increasing on the back of greater fixed infrastructure

Figure 6: Average new lease length by sector

Source: MSCI

UK CAPITAL VIEW:

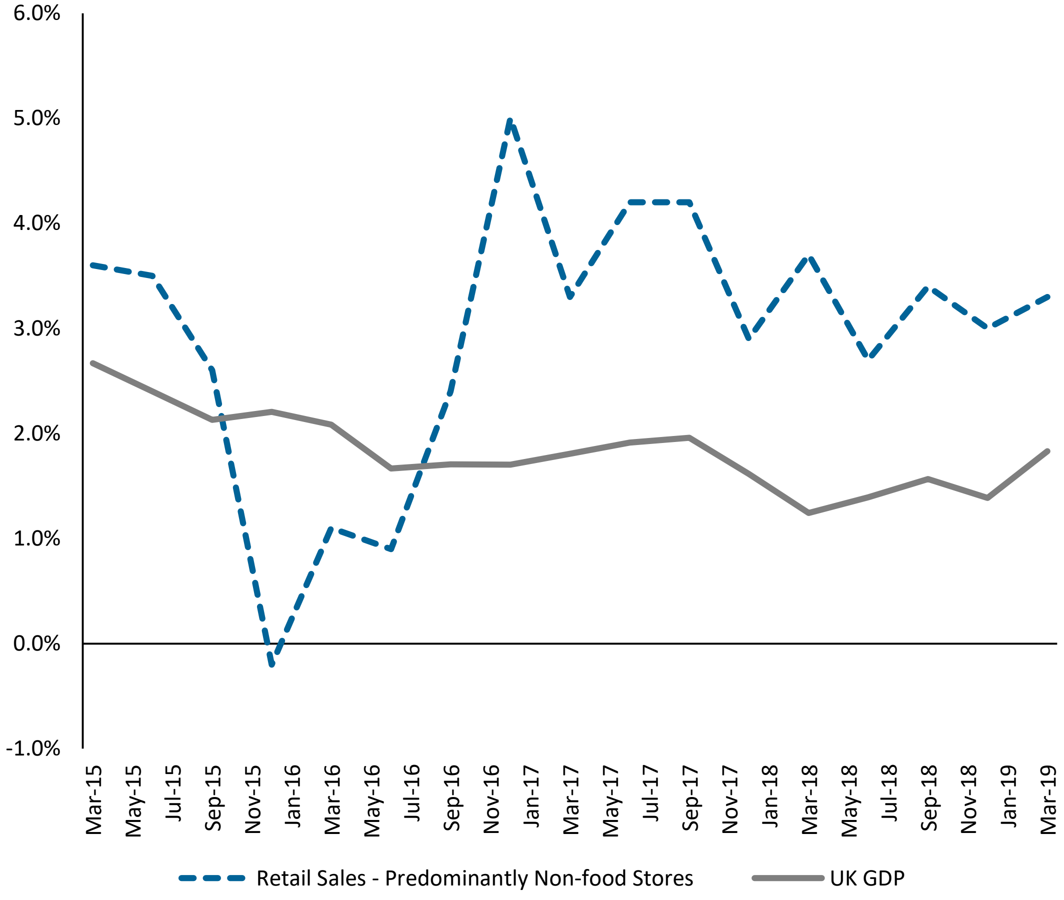
HIGH STREET RETAIL

Focus on High Street assets that have had their rents re-based over the last 12-18 months

- **The nation's High Streets have en masse received plenty of negative commentary. However, it is important to distinguish between "strong" and "weak" High Streets when analysing the sector.**
- Occupier markets in High Streets of the top 50-75 towns generally remain healthy with limited vacancies, and these prime streets continue to attract the highest footfall being focal points where people live, work and shop.
- High Streets are also generally open 24 hours a day and attract a wide range of retail uses including all A Classes (shops, banks, cafes), B1 (offices), C1-C4 (residential, hotels, nursing homes) and D1-D2 (cinemas, gyms, health centres).
- Existing or future tenants should be attracted to the lower occupational costs of High Streets when compared to their Shopping Centre counterparts, where service charges significantly increase overall property costs.
- Despite the perception that all retail landlords are at the mercy of their tenants, High Street owners do not have the same 'gun to the head' scenario that some multi-let landlords are facing. Owners have the benefit of being able to select a tenant that is willing to pay the highest rental rate, without the same level of concern over the tenant mix of the asset.
- Investors should focus on High Street assets that have had their rents re-based over the past 12-24 months to ensure that they are at an affordable level for the tenant to be profitable. These re-based rents should provide sufficient protection on the downside to landlords until the currently fragile occupier market improves.
- The High Street sector provides a strong liquidity story due to the range of lot sizes available, appealing to a diverse range of buyers including; funds, property companies who may envisage potential alternative use upside (office or residential) or private buyers seeking wealth preservation.
- Whilst many institutional owners have proceeded to sell down their High Street assets in order to raise capital and reduce their portfolio weightings towards retail, we envisage that investors will look to re-stock their portfolios with high quality High Street assets in future years.

Annual retail sales growth is outpacing UK GDP growth

Figure 7: UK retail sales and GDP annual growth



Source: BRC

UK CAPITAL VIEW:

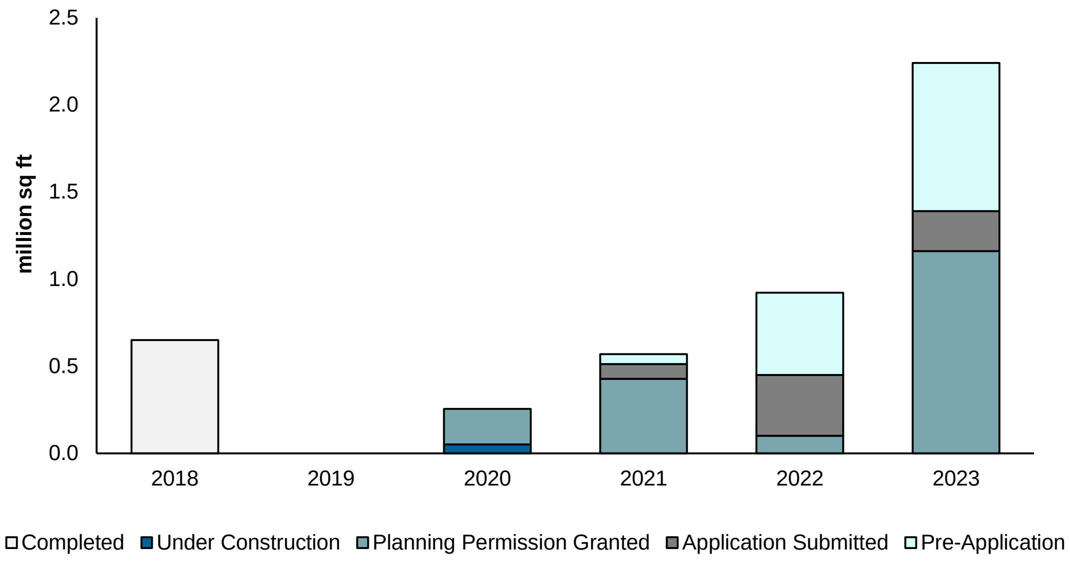
SOUTH BANK OFFICE

Take advantage of the revitalisation across London's third core office market

- **With a continued shortage of appropriately priced prime assets within the traditional Central London core office markets of the West End and the City, investors are looking to adjacent submarkets such as London's Southbank.**
- As such, the Southbank has become a commercial market hotspot in recent years with occupier take-up reaching above average levels of 890,000 sq ft in 2018. There is currently only 50,000 sq ft of office space currently under construction in the Southbank, all of which is pre-let. There is however potential of up to one million sq ft of office space to be speculatively delivered to the market over the next three years.
- Although on the face of it, this level of construction activity is high by historical standards, developers will likely pursue a pre-let in order to achieve more attractive debt terms and to de-risk a project. As a result, the completion dates of many proposed development projects could be extended.
- Occupier demand remains strong in the area and of the 4.2 million sq ft of active requirements for space in the City office market. As tenants become more footloose, we expect a number of these tenants will consider being based in the adjacent Southbank. Prime rents in Southbank have increased 3.6% over the 12-months to Q1 2019, and Knight Frank forecast a further increase of 10% over the next three years.
- Southbank also benefits from access to a number of mainline train stations, such as Waterloo and London Bridge, which link the south of England and south London commuter belt.
- Urban regeneration projects in Southbank and the neighbouring Battersea, Nine Elms and Elephant & Castle have so far been largely residential focused. Development sites have been harder to come by for office investors, as this has not been the highest and best use of the land. However, with a moderating Central London residential market, we expect increased opportunities for investors to purchase sites that were previously earmarked for residential development.

Tenant demand outpacing development pipeline in the medium term

Figure 8: South Bank office development pipeline by status



Source: Knight Frank

UK CAPITAL VIEW:

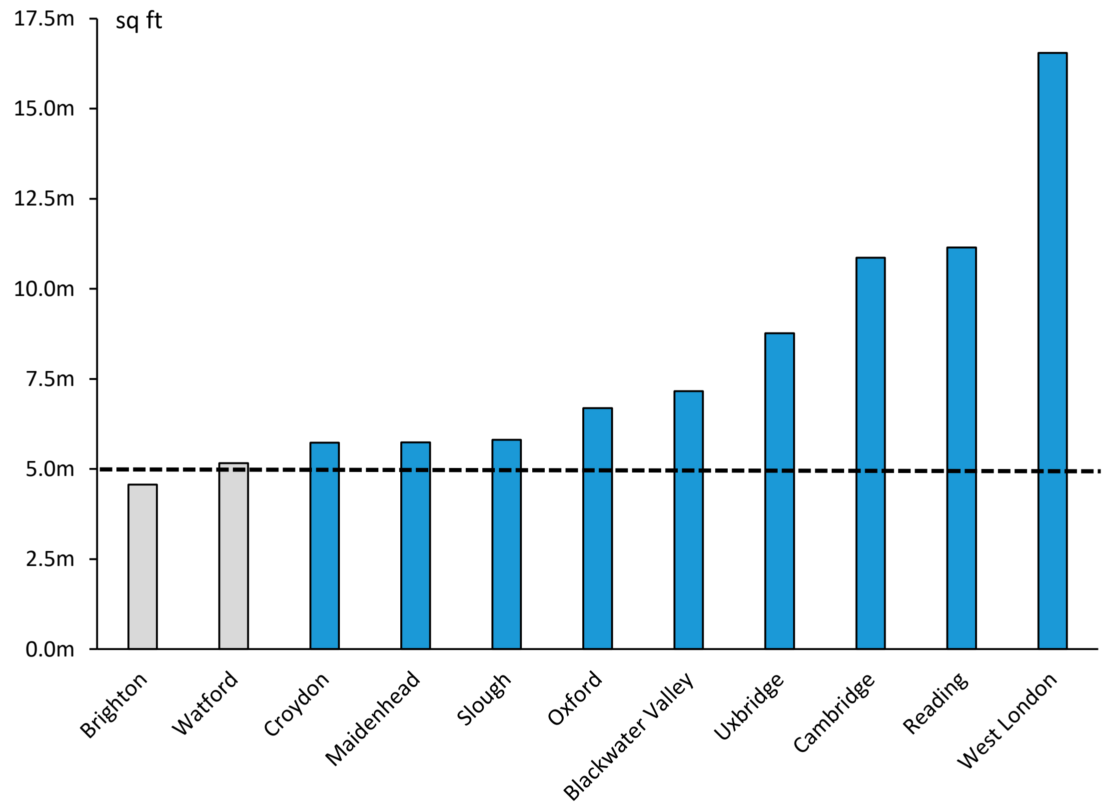
SOUTH EAST OFFICE

Which South East Office markets can expect to see interest from cross-border capital

- **As competition for prime London office assets remains high, cross-border investors are having to increasingly look at office markets like the South East for investment opportunities.**
- Although the South East office market as a whole is an established institutional grade investment market, there are disparities in market size across the different towns within the region.
- Specialist domestic institutional investors have historically deployed more capital into smaller, less liquid South-Eastern towns, both global cross-border investors are increasingly looking to expand into these regions.
- Knight Frank have analysed the flows of cross-border capital into major towns in the South East and have identified that regional towns see international investors enter office markets whereby stock levels exceed five million sq ft of floor space.
- Figure 9 highlights the major regional towns in the South East which have seen cross-border capital investment over the last 15-years. Croydon, Uxbridge and the West London region sit within the M25 and enjoy close proximity to Central London. Maidenhead, Slough and Reading sit along the M4 corridor, which was one of the first tech hubs generated through the 1980's and 1990's. These markets, along with the university towns of Oxford and Cambridge have attracted investment from cross-border investors.
- Watford and Brighton are examples of markets where domestic institutions have been investing into their smaller occupier markets, but cross-border investors are yet to follow suit. Given the healthy demographic drivers underpinning wealth creation in these markets it is anticipated that both the size and quality of the stock in these markets could increase to a level suitable for institutional cross-border investors in the near-term.

Cross-border investors gravitate to office markets with stock greater than 5 million sq ft

Figure 9: M25 Office Market Sizes (sq ft)



Source: PMA

UK CAPITAL VIEW:

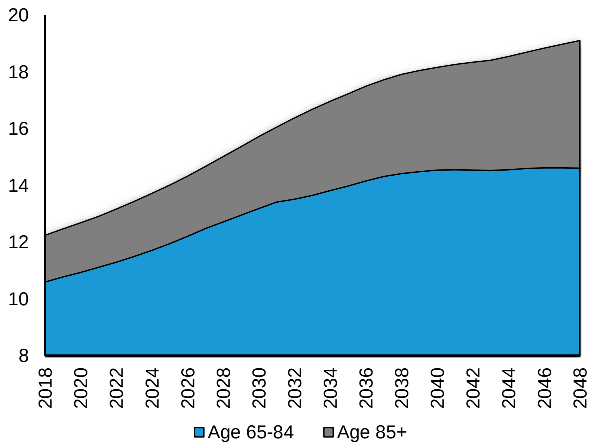
HEALTHCARE

Strong long-term demographic trends helping to drive investment demand

- **The growing pool of funds looking to gain exposure to the UK real estate sector has pushed returns lower across the traditional core sectors and increased the level of competition for assets. This is encouraging investors to look into other real estate sectors that are supported by longer term demographic trends.**
- Growth in the UK's 65+ population is fuelling investor interest in the healthcare sector. Occupancy rates in 65+ care homes are already reaching record highs at close to 90%, even before the ageing "time-bomb" approaches.
- Investor demand is also being shaped by a broader appetite for specialist sectors with pricing of core real estate assets at record highs and investors searching for attractive risk-adjusted returns with a long-term horizon.
- Healthcare property fits the mould with long-dated income, typically comprising 30-year lease terms, and increasing liquidity across the UK market as the sector continues to evolve. However, these benefits do however come with unique operational and potential reputational risk for prospective investors.
- Furthermore, healthcare property is becoming more diverse as a sector. Elderly care homes have long provided the most accessible and scalable investment of all the healthcare sub-sectors, but we are now seeing growing interest in a number of other sub-sectors. These include adult care homes & supported living residences, primary care facilities, private hospitals and childcare.
- Specialist REITs have been the largest buyers in these sub-sectors, with pricing on these assets ranging from 4.0-6.0% initial yield. However traditional real estate investors are increasingly looking at the sector.
- Given the strength of investor demand and demographic drivers, it is not surprising that total returns for the healthcare sector have outpaced All UK Property on an annual basis (9.3% vs 4.5%).
- While, healthcare has benefitted from capital growth on the back of cap rate compression, the stronger income profile of the sector has also provided investors with a stable income return of 5.5% over the 12-months to March 2019.

Demand projected to continue to rise

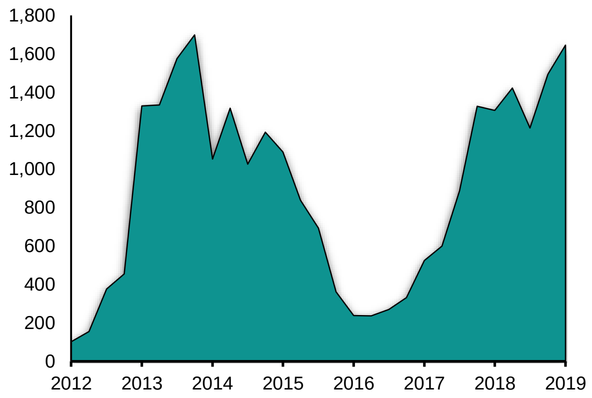
Figure 10: +65 population: 30-year projection (persons, millions)



Source: ONS

Investment activity has recovered following the post-referendum lull

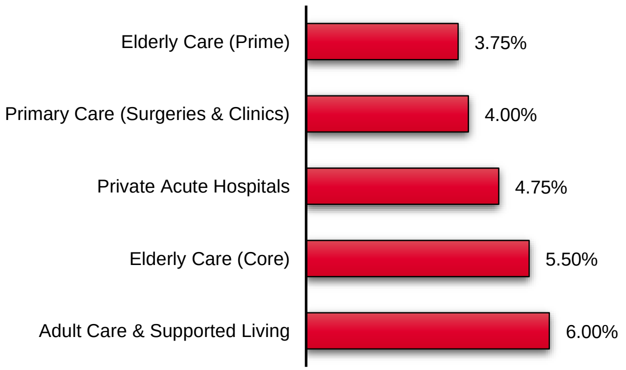
Figure 11: Total healthcare investment volumes (£M, rolling annual)



Source: PropertyData

Investor demand is pushing investment yields lower across all healthcare sub-sectors

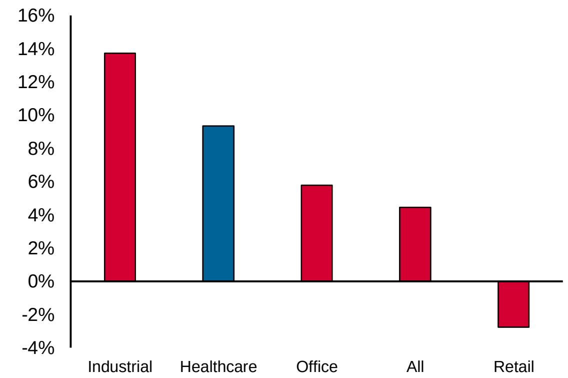
Figure 12: Average healthcare property yields (Net Initial Yield)



Source: Knight Frank

Investor and occupier demand is helping spur returns

Figure 13: Total Returns by sector



Source: MSCI, Knight Frank

UK CAPITAL VIEW:

RESIDENTIAL INVESTMENTS

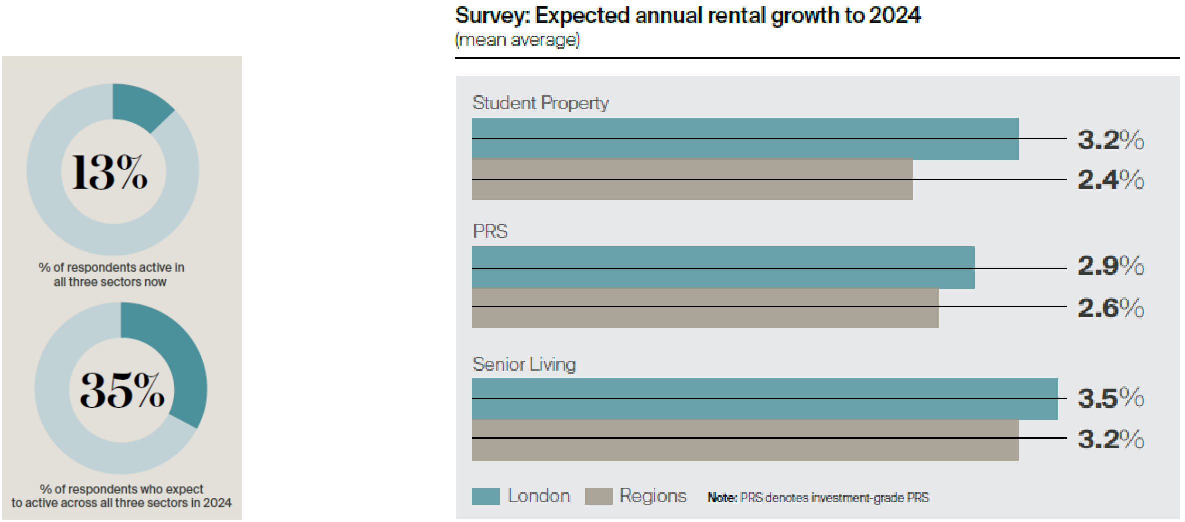
Residential Investments sector to reach £146bn by 2025

- Residential markets, have vast market size growth potential and provide an attractive alternative to the more regulatory heavy and operationally challenging healthcare market.
- The residential sector continues its rapid expansion across the purpose-built student accommodation (PBSA), purpose-built rented accommodation (PRS) and Senior Living sub-sectors.
- The recent Knight Frank survey of 43 leading investors in residential investments, representing £32bn of investment across the sectors, indicates that appetite for student property will remain steady over the short to medium term, while investors anticipate notable growth in investment activity across the PRS and senior living sectors in the UK.
- The survey points to an increased diversity in residential investments in the future, with investors spreading their exposure across age groups and geographies.
- Synergies in the construction and management of these markets and low correlation attributes of the residential income stream when compared to the more traditional real estate markets, make diversifying into the sector increasingly appealing for investors.
-
- Residential rental growth has outpaced inflation over the last 10-yrs, growing on average by 2.7% p.a., while rental growth for student property has averaged 3.1% p.a.
- Survey respondents expect rental growth to continue close to current levels over the next five years, with a slight uptick for London student property. Investors in PRS also expect rental growth for London to be stronger than in the regions. The senior living sector is expected to record slightly stronger growth across the UK.
- Looking to the future, between 2019-2025 Knight Frank forecasts the PBSA market will mature from a £51bn to £65bn market, investment grade PRS will grow from a £35bn to £75bn market (in terms of both value of assets and total capital committed), and the senior living rental market will expand from a £1.3bn to £5.9bn market.

Figure 14: Size of residential markets

	Student Property	PRS	Senior Living
	Purpose-Built Student Accomodation (PBSA). For this purposes of this report, it includes university-run and private Student Property.	Large-scale accomodation built specifically for rental, including new-build "Build-to-Rent" schemes.	Purpose-built rental accomodation specifically for older people, with a range of domicilary or nursing care available as needed
Market type	Mature	Expanding	Establishing
Beds/Units	600,000	30,000*	4,000**
as % of relevant sector	33%^	2.60%	0.7%^^
% total housing stock		0.42%	0.01%

Figure 15: Knight Frank Investor Survey Results



Source: Knight Frank Residential Investment Survey 2019

UK CAPITAL VIEW:

UK CAPITAL MARKETS

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	Mar-19	Apr-19	May-19	Market Sentiment
High Street Retail				
Bond Street	2.25%	2.25%	2.50%	Stable
Oxford Street	2.50%	2.50%	2.75%	Negative
Prime Shops	4.50% - 4.75%	4.75%	4.75% +	Negative
Regional Cities	5.00% - 5.25%	5.25%	5.25% +	Negative
Good Secondary (Truro, Leamington, Spa, Colchester etc)	6.50% +	6.50% +	6.50% +	Negative
Secondary & Tertiary	10.00% ++	10.00% ++	10.00% ++	Negative
Shopping Centre				
Regionally Dominant (£200+ psf Zone A)	5.25%	5.25%	5.25%	Negative
Dominant Prime	7.25%	7.25%	7.25%	Negative
Town Dominant	9.00%	9.00%	9.00%	Negative
Secondary	10.00% ++	10.00% ++	10.00% ++	Negative
Out of Town Retail				
Open A1/Fashion Parks	5.50% +	5.50% +	5.50% +	Negative
Secondary Open A1 Parks	6.75% +	6.75% +	6.75% +	Negative
Bulky Goods Parks	6.00% +	6.00% +	6.00% +	Negative
Secondary Bulky Goods Parks	7.50% +	7.50% +	7.50% +	Negative
Solus Open A1	5.00% +	5.00% +	5.00% +	Negative
Solus Bulky (c.50,000 sq ft let to strong covenant)	5.50%	5.50%	5.50%	Negative
Specialist sectors				
Dept. Stores Prime (with fixed uplifts IY)	8.00%	8.00%	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)	4.00%	4.00%	4.00%	Stable
Student Accommodation (Prime London - Direct Let)	4.00%	4.00%	4.00%	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	4.75% -	4.75% -	4.75%	Positive
Warehouse & Industrial Estates				
Prime Distribution/Warehousing (20 yr income with fixed uplifts IY)	4.00%	4.00%	4.00%	Stable
Prime Distribution/Warehousing (15 yr income)	4.25%	4.25%	4.25%	Stable
Secondary Distribution (10 Yr income)	5.00%	5.00%	5.00%	Negative
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	5.75% +	6.00%	6.00%	Stable
Offices				
City Prime	4.25% - 4.50%	4.25% - 4.50%	4.25% - 4.50%	Stable
West End Prime	3.50% +	3.50% - 3.75%	3.50% - 3.75%	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