Lambert Smith Hampton

THE LIVING QUARTER

UKIT Q119

UK INVESTMENT TRANSACTIONS BULLETIN

Q1 VOLUME AT £10.9BN: LOWEST SINCE Q3 2016

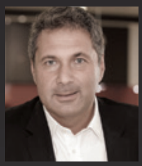
OFFICE VOLUME SLUMPS TO TEN-YEAR LOW

NON-CORE SECTORS: 54% OF VOLUME

BUILD TO RENT AND HOTELS BUCK TREND

AVERAGE TRANSACTION YIELD UP 14BPS

RETAIL VOLUME AT RECORD LOW



Ezra Nahome
CEO

Q1's weak volume should come as no surprise, as investors were always likely to delay decisions ahead of the UK's planned EU exit date in March. However, the ongoing strength of activity in the 'living' sectors underlines just how much the market has changed over the past decade.

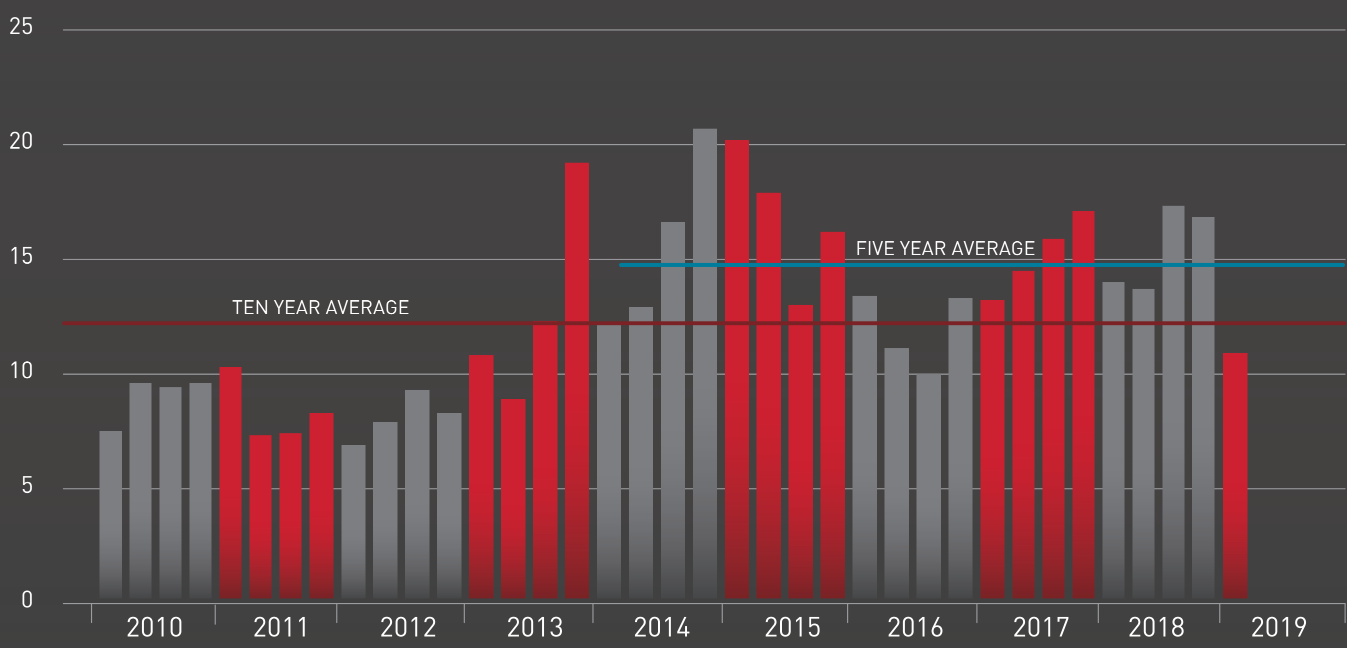
It was to be hoped that Q1 would be an isolated quarter and that greater clarity of Brexit would have emerged by now. While we did not crash out of the EU, the Brexit extension means that uncertainty is likely to continue to hang over both the wider economy and investment market for at least two more quarters.

However, we believe that a realistic, moderate degree of Brexit risk is already priced into UK property. UK Real Estate remains an attractive asset class and investors should therefore look through the Brexit fog and concentrate on property fundamentals when assessing the market.

The rise of the once alternative sectors into the mainstream also underlines the broadening appeal of secure income, particularly in the current market. The ongoing strength of activity across the living sectors – including PRS, hotels, and student property – was remarkable during Q1, and for the first time ever, total investment in non-core sectors surpassed the three traditional mainstream sectors combined.

The strong run of form for the living sectors shows no sign of ending, and it may prove to be the defining feature of the investment market in 2019. These sectors can no longer be seen as quirky, specialist areas, and are now a fundamental part of the UK Real Estate landscape.

UK INVESTMENT VOLUME (£BN)



Source: LSH Research, Property Data, Property Archive/PMA

SECTOR FOCUS

THE LIVING QUARTER

A strong finish to 2018 quickly gave way to subdued volume in Q1 2019, with investor caution around Brexit weighing most clearly on the traditional core sectors.

At £10.9bn, total Q1 volume was the lowest since Q3 2016 in the aftermath of the EU Referendum. While volume was only 26% below the five-year quarterly average, the contrast with the previous quarter was stark; down 34% on Q4 2018 and the largest quarter-on-quarter percentage fall in five years.

The impasse was particularly evident at the larger end of the market. Q1 saw only 19 deals above £100m, the lowest since Q4 2012 and significantly below the average of 31. The total number of deals in Q1 was in fact only 13% below average, indicating a stronger tolerance to uncertainty across the wider market.

OFFICES HIT HARDEST

Offices took the brunt of the drop-off in Q1 volume, slumping by 60% quarter-on-quarter to a ten-year low of £2.7bn. While subdued activity was evident across the three office segments, Central London was the main drag overall, with volume of £1.8bn being less than half the average.

Only two Central London office deals above £100m changed hands in Q1, the lowest number since Q1 2009. The largest was Dukelease Properties' £121m (4.95% NIY) purchase of 42-47 Minories, EC3 from Harel Insurance.

UNFLAPPABLE ALTERNATIVES

Meanwhile, the specialist/alternative sectors continued to see strong activity, reflecting ongoing appetite for long-income deals and diversification. Amid a subdued Q1 for the three core sectors, for the first time on record, alternatives collectively accounted for more than half of total volume.

Hotels & leisure was Q1's standout sector, with £2.6bn of assets changing hands, the highest in over a decade. This included the UK's largest deal in Q1, Queensgate Investments' £1bn acquisition of the Grange Hotel Portfolio, together with an Israeli investment fund's £250m purchase of the Hallmark Hotels Portfolio from Topland Group.

Q1 provided further evidence of the growing traction in the emerging build to rent asset class. The quarter saw 12 forward-funding deals, including the second largest deal of the quarter, in which PSP Investments and QuadReal each acquired a 37.5% stake in a £670m, 1,200 unit project at Westfield Stratford City in London.

Q1 2019 INVESTMENT VOLUME (£BN)

VOLUME VS 5YR QTY AVG

-50% | -25% | AVERAGE | +25% | +50%

SECTOR	Q1 2019	Q4 2018	Q3 2018	Q2 2018	VS Q4 2018 (%)
Shops	0.61	0.81	0.67	1.10	-24%
Shopping Centres	0.05	0.40	0.04	0.22	-88%
Retail Warehouse	0.41	0.24	0.77	0.63	66%
ALL RETAIL	**1.06**	**1.45**	**1.47**	**1.95**	**-26%**
Central London Offices	1.79	4.27	4.50	4.67	-58%
Rest of South East Offices	0.34	0.56	0.91	0.75	-39%
Rest of UK Offices	0.34	1.64	0.97	0.71	-80%
Office Parks	0.20	0.26	0.40	0.34	-22%
ALL OFFICE	**2.67**	**6.73**	**6.77**	**6.48**	**-60%**
South East Industrial	0.23	0.39	0.31	0.31	-41%
Rest of UK Industrial	0.40	0.83	0.96	0.64	-52%
Distribution Warehouse	0.76	1.08	0.92	1.00	-29%
ALL INDUSTRIAL	**1.39**	**2.29**	**2.19**	**1.94**	**-40%**
Hotels & Leisure	2.64	1.30	1.24	1.33	103%
Specialist	2.65	2.76	3.51	2.02	-4%
Mixed-use (single assets & portfolios)	0.54	2.04	1.85	0.37	-73%
ALL PROPERTY	**10.95**	**16.57**	**17.04**	**14.07**	**-34%**

Source: LSH Research, Property Data, Property Archive

Q1 2019 YIELDS

SECTOR	TRANSACTION YIELDS Q1 2019	TRANSACTION YIELDS 3 MONTH MOVEMENT (BPS)	TRANSACTION YIELDS 12 MONTH MOVEMENT (BPS)	PRIME YIELDS Q1 2019	PRIME YIELDS 3 MONTH MOVEMENT (BPS)	PRIME YIELDS 12 MONTH MOVEMENT (BPS)	YIELD SENTIMENT
Shops	4.64%	70	-21	4.50%	25	50	◁▷
Shopping Centres	N/A	-	-	6.75%*	25	75	△
Retail Warehouse	6.10%	46	-32	5.50%	25	100	△
ALL RETAIL	6.21%	68	10	-	-	-	-
Central London Offices	4.46%	-2	24	3.75%	25	25	◁▷
Rest of South East Offices	5.61%	-43	-99	4.75%	-25	-25	◁▷
Rest of UK Offices	6.66%	34	53	4.75%	◀▶	◀▶	◁▷
Office Parks	7.48%	56	102	5.25%	◀▶	◀▶	△
ALL OFFICE	5.20%	◀▶	12	-	-	-	-
South East Industrial	4.07%	-64	-111	3.75%	◀▶	◀▶	◁▷
Rest of UK Industrial	6.49%	74	-18	4.75%	◀▶	◀▶	◁▷
Distribution Warehouse	5.04%	-23	-69	3.75%	◀▶	◀▶	▽
ALL INDUSTRIAL	4.79%	-27	-82	-	-	-	-
Hotels & Leisure	4.91%	-6	-86	4.25%	◀▶	◀▶	◁▷
Specialist	4.49%	-138	-130	5.00%**	◀▶	◀▶	◁▷
Mixed-use (single assets & portfolios)	6.02%	77	89	-	-	-	-
ALL PROPERTY	5.48%	14	-19	-	-	-	-

* Sub regional centres
** Student accommodation (Regional, direct-let)

Source: LSH Research, Property Archive/PMA, Property Data

RETAIL AT ROCK BOTTOM

A perfect storm of Brexit uncertainty and turmoil on the high street saw retail volume sink to an all-time low of £1.1bn in Q1. While activity was subdued across all sub-sectors, the market for shopping centres was moribund. Tellingly, the largest shopping centre deal in Q1 was bought for alternative use, namely Tikehau Capital and Areli Real Estate's £25m receivership purchase of the Nicholsons Centre, Maidenhead.

BACK TO NORMALITY FOR INDUSTRIAL

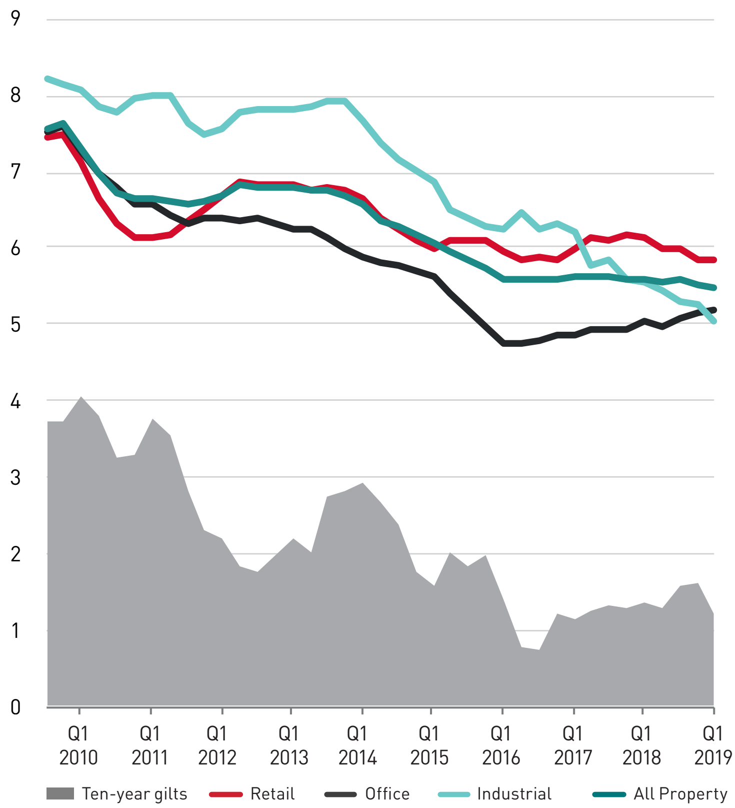
At £1.4bn, industrial volume was 40% below Q4 2018's record total but only 18% below trend. The market remained busy from a deals perspective, however, with the fall largely reflecting a thinning in large lot-size/portfolio deals. Furthermore, Tritax Big Box REIT's acquisition of an 87% stake in DB Symmetry, arguably Q1's headline industrial deal, is excluded from the volume figure.

YIELD EDGES UP FROM DECADE LOW

The All Property average transaction yield moved out by 14bps during Q1, albeit from an 11-year low, to stand at 5.48%. Further falls in retail property prices were evident in Q1; average retail transaction yields moved up by 68bps to 6.21% while prime notional yields softened by circa 25 basis across each of the retail sub-sectors.

In stark contrast, the average industrial yield fell below the 5% mark in Q1 to stand at a record low of 4.79%. Although this demonstrates the strength of values in the sector, it also arguably reflects a recent refocusing of buying interest on defensive product in light of weakening economic sentiment.

ROLLING ANNUAL TRANSACTION YIELDS AND 10-YEAR GILTS (%)



Source: LSH Research, Experian

REGIONAL FOCUS

LONDON LIMPS

Brexit uncertainty prevailed across the UK in Q1, with volume in the regions and particularly London notably below trend. Portfolio volume was also under par despite being boosted by major hotels and leisure deals.

GREATER LONDON VOLUME SLUMPS

At £4.2bn, Greater London volume in Q1 was the lowest in ten quarters and slumped by 39% quarter-on-quarter. This largely stemmed from a very quiet quarter for central London offices, with a lack of major deals transacting.

Volume was nonetheless bolstered by strong activity in the specialist sectors, reaching a record £1.3bn in the capital. This included four major build to rent deals alongside Greystar, PSP Investments and Allianz's £160m (3.75% NIY) student accommodation acquisition at Paul Street East, EC2 from Apache Capital.

REGIONAL VOLUME RETREATS

At £3.9bn, volume for single-asset deals in the UK regions was down 32% on Q4 2018 and 23% below the five-year quarterly average. The only two UK regions to see volume in Q1 above trend were the East and Yorkshire & the Humber, up 68% and 35% on their respective five-year quarterly averages.

While retail activity has been weak for some time, a key drag on Q1 volume in the regions was subdued activity for offices, while distribution warehouses and the specialist sectors held up. The largest deal in the UK regions was Delancey's £200m forward funding of an 800 unit build to rent scheme at Middlewood Locks, Manchester.

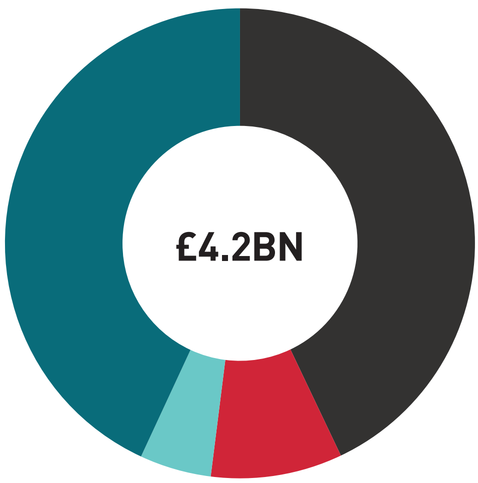
HOTELS & LEISURE UNDERPIN PORTFOLIO VOLUME

£2.9bn of portfolios transacted during Q1, down 21% on the five-year quarterly average. The under par performance was seen across the majority of sectors, excluding hotels & leisure.

£2.1bn worth of hotels & leisure portfolios changed hands across seven deals in Q1, almost three times the five-year quarterly average. While ten deals transacted in Q1, volume was dominated by the £1.0bn Grange Hotel Portfolio.

Q1 2019 LONDON AND REGIONAL BREAKDOWN (£BN)

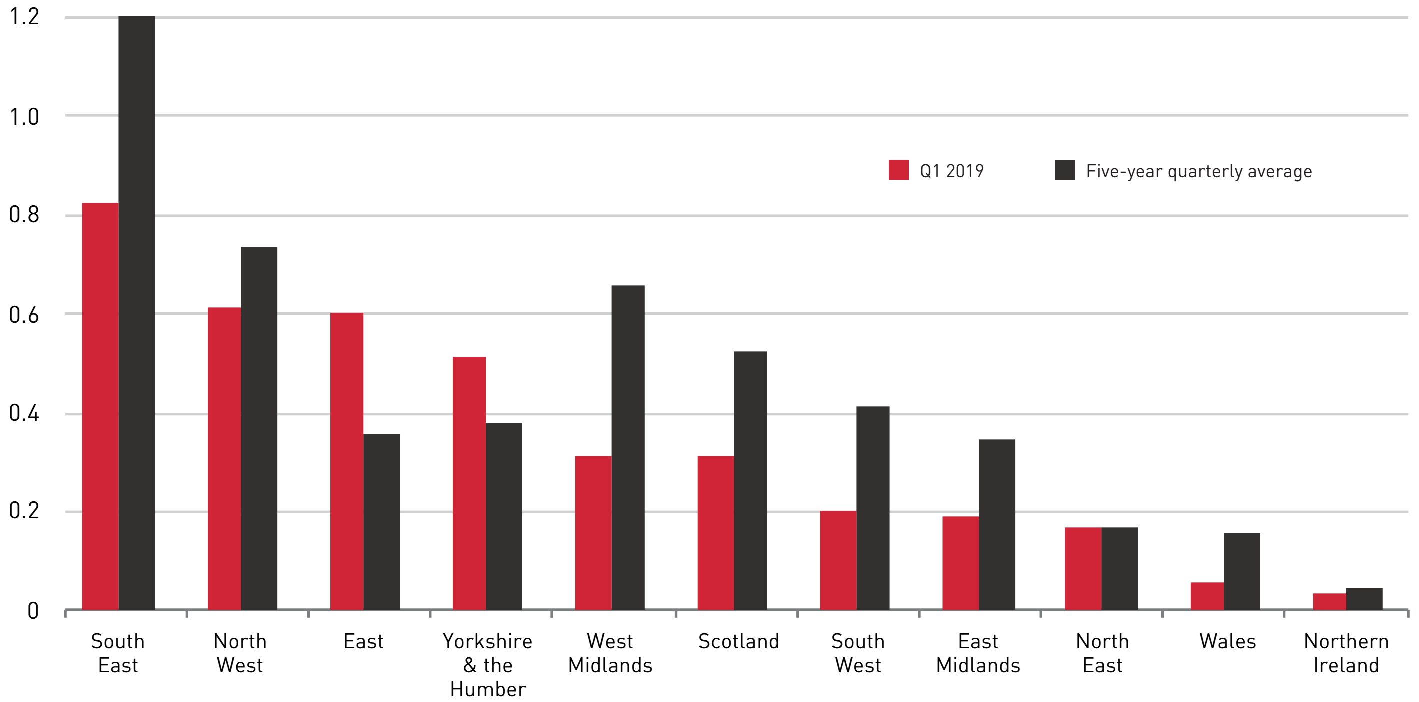
OFFICE
INDUSTRIAL
RETAIL
OTHER/MIXED USE



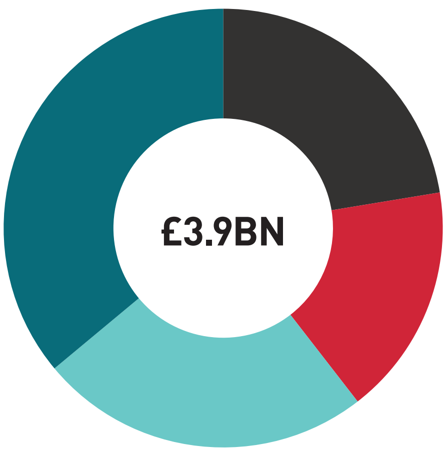
GREATER LONDON

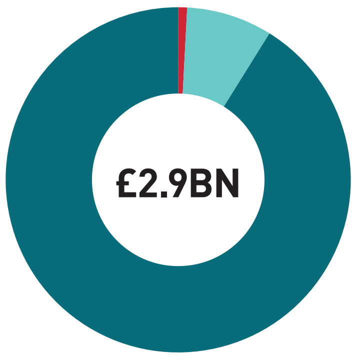
VS Q4 2018	-39%
VS Q1 2018	-23%
VS FIVE-YEAR QUARTERLY AVERAGE	-32%

Q1 REGIONAL INVESTMENT VOLUME (£BN)



Source: LSH Research, Property Data, Property Archive/PMA





UK REGIONS	PORTFOLIOS
-32%	-27%
-35%	8%
-23%	-21%

Source: LSH Research, Property Data, Property Archive

BUYERS & SELLERS

ALTERNATIVES ALLURE

Amid heightened caution across the main investor groupings in Q1, the appetite for alternative assets remained resilient across the board.

OVERSEAS INVESTMENT WEIGHS ON VOLUME

At £5.0bn, total overseas investment was the lowest quarterly volume since Q2 2016 and 28% below trend level. However, the influx of overseas capital to UK real estate remains substantial, with net investment amounting to £3.3bn in Q1.

Under par overseas activity manifested itself in weak investment in London and a drop-off in major lot-size deals; Q1 saw ten deals to overseas buyers above £100m compared to an average of 19. Meanwhile, however, overseas investment in hotels & leisure was its highest on record at £2.0bn.

Following record investment in Q4 2018, Far East volume of £1.3bn in Q1 was the lowest since Q4 2016. Meanwhile, Middle East volume reached £830m, up 20% on the five-year quarterly average.

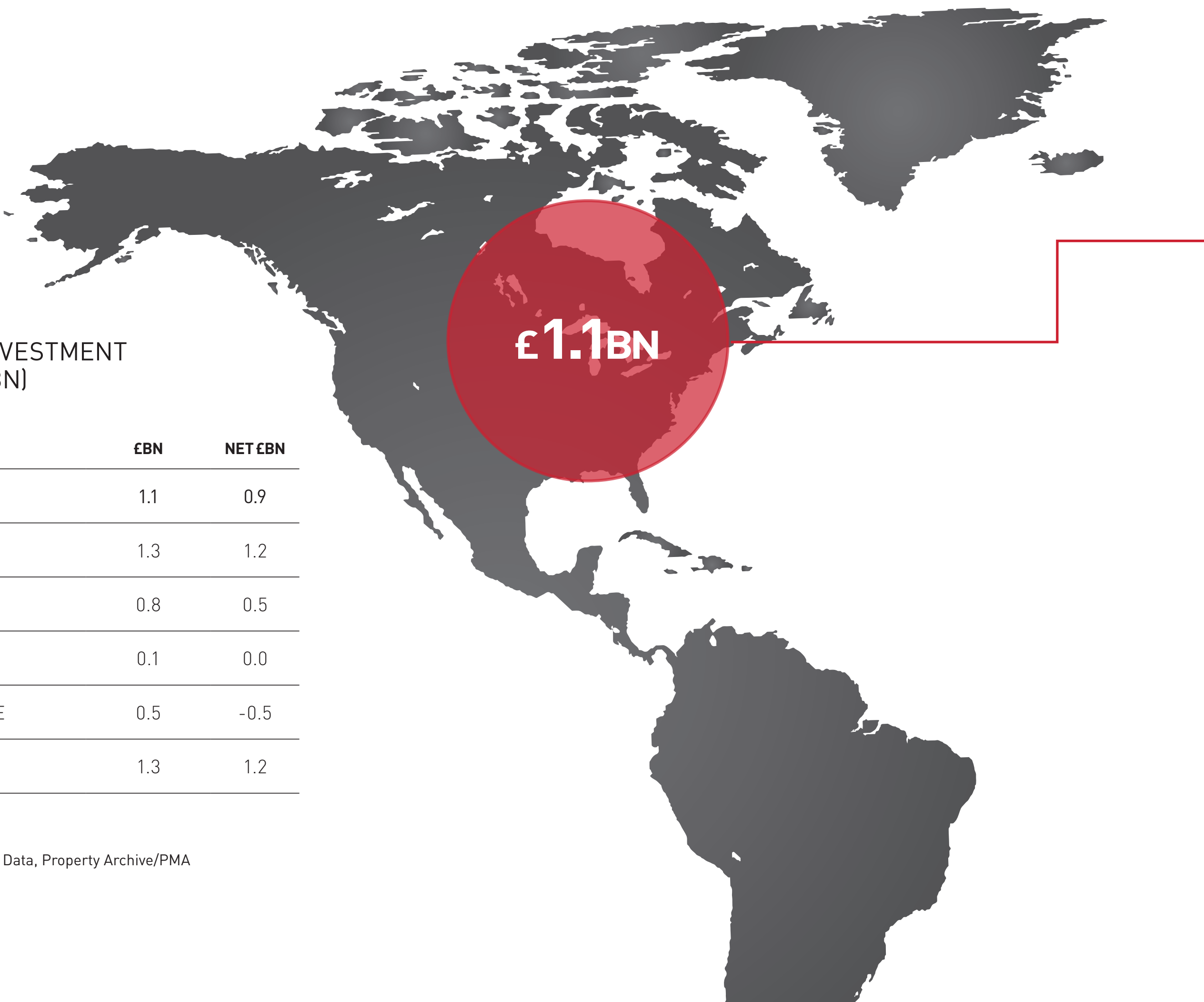
INSTITUTIONS GO QUIET IN Q1

At £2.0bn, investment from institutions was also subdued in Q1, down 26% on the previous quarter and 35% below the five-year quarterly average. However, institutions were notably acquisitive in the hotels & leisure sector, the largest deal being M&G's £203m forward funding of a hotel complex in Paddington, London.

Indeed, M&G was the most active institutional buyer in Q1, acquiring £480m worth of assets across hotels & leisure, build to rent and distribution warehouses.

PRIVATE PROPCOS REMAIN BUSY

Bucking the above trend, private propcos' investment of £1.9bn in Q1 was up 32% on Q4 2018 and 12% above the five-year quarterly average. Arguably sensing value in the market, they were the largest purchasers of retail assets in Q1, accounting for almost 50% of volume. Private propcos were also the largest sellers in Q1 disposing of £2.7bn, capitalising on strong demand for alternatives.

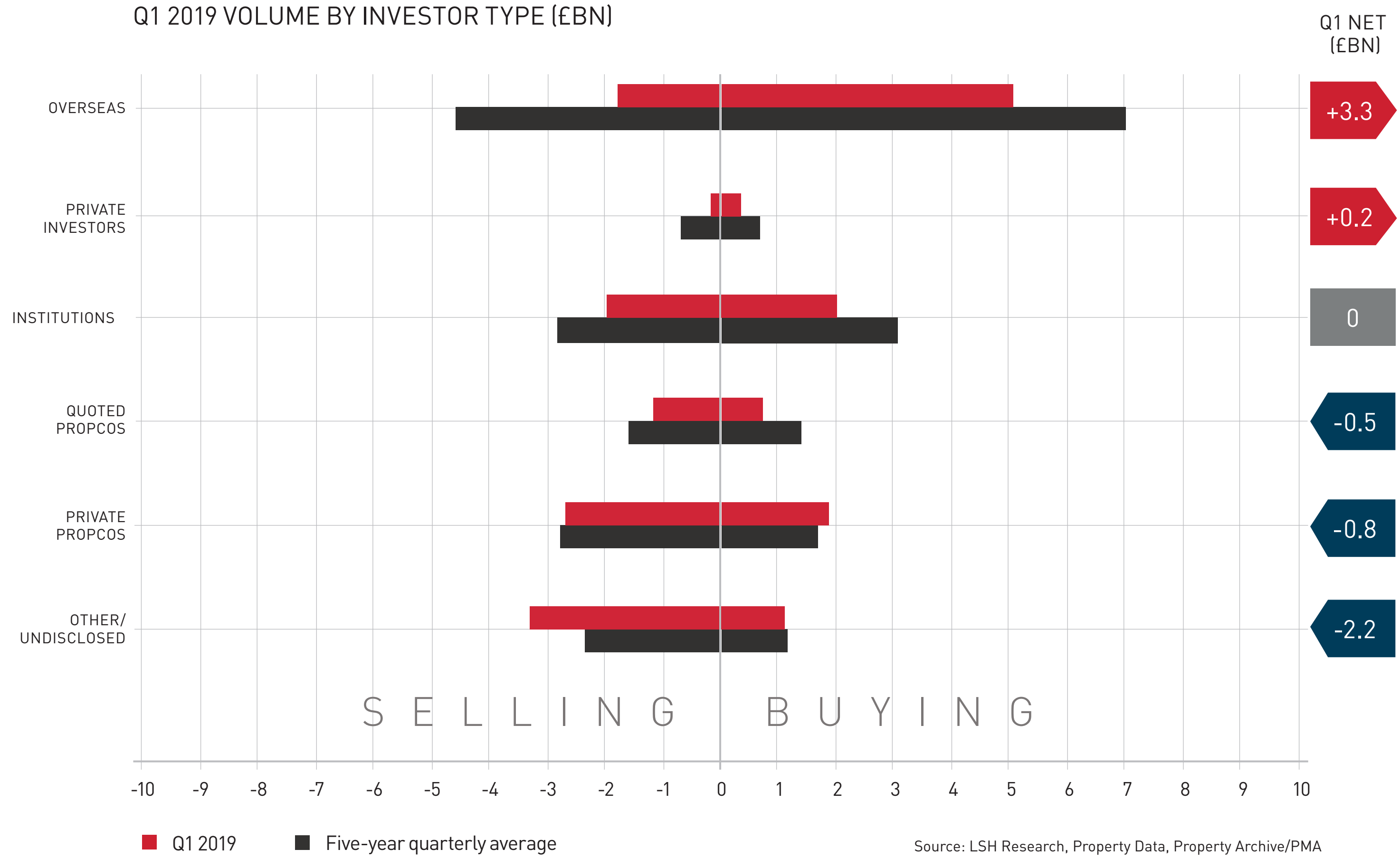


Q1 2019: GLOBAL INVESTMENT FLOWS INTO UK (£BN)

ORIGIN	£BN	NET £BN
NORTH AMERICA	1.1	0.9
FAR EAST	1.3	1.2
MIDDLE EAST	0.8	0.5
GERMANY	0.1	0.0
REST OF EUROPE	0.5	-0.5
OTHER	1.3	1.2

Source: LSH Research, Property Data, Property Archive/PMA

Q1 2019 VOLUME BY INVESTOR TYPE (£BN)



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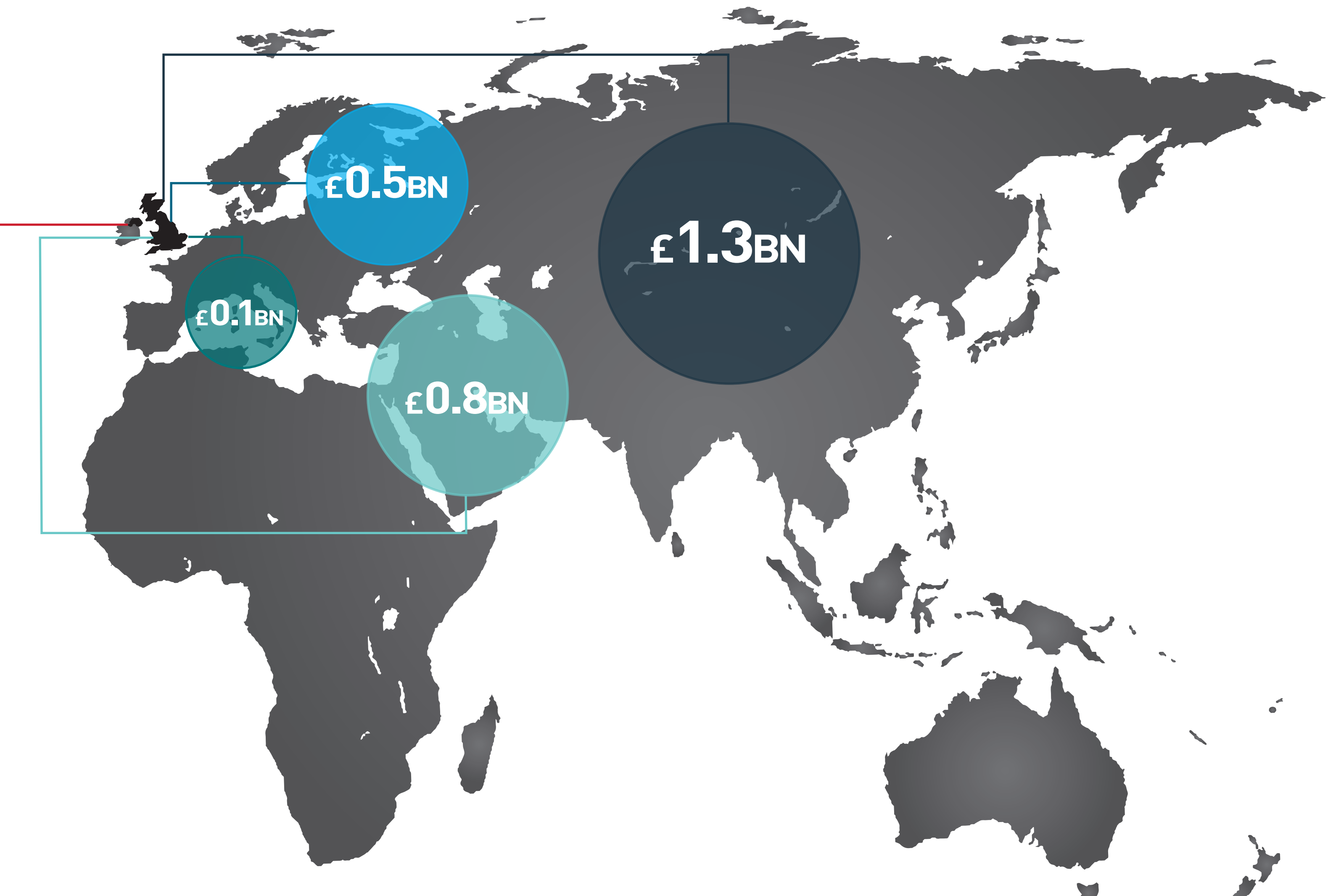


OUTLOOK

BREXIT LIMBO

The extension of the Brexit deadline will prolong the uncertainty impacting the wider UK economy.

BREXIT DELAYED

With parliament unable to agree on the terms of the UK's departure from the European Union, Brexit has been delayed until the end of October. A flexible extension has been agreed, which would allow the UK to leave earlier if parliament ratifies the proposed withdrawal agreement.

However, with cross-party talks showing little signs of progress, a Brexit resolution remains elusive. It may yet take a leadership challenge to Theresa May or a general election to break the political impasse. Brexit could still rumble on past the October deadline.

ECONOMY MAKES SLOW PROGRESS

Brexit does appear to be weighing on economic sentiment, but UK GDP actually beat expectations in the three months to February, with growth of 0.3%. This was, though, boosted by manufacturers' stockpiling in anticipation of Brexit.

Nonetheless, the economy remains fragile and Purchasing Managers Index (PMI) data suggests that growth came to a virtual standstill in March. The PMI figures suggest that overall GDP growth for Q1 may only just be in positive territory.

GLOBAL OUTLOOK BRIGHTENS

The UK's moderate growth in recent quarters is not just a reflection of domestic concerns. It is also consistent with the global economy hitting a soft patch, due in part to trade tensions between the US and China.

However, more positive indicators are now emerging from the global economy. GDP growth in the US and China beat expectations in Q1, and improving data has come from the Eurozone. These brighter signs will fuel hope that the UK may avoid hitting a 'perfect storm' of Brexit coming amid a serious global downturn.

LABOUR MARKET POWERS ON

Throughout the recent uncertainty, the UK labour market has been a source of consistently positive news. A record 32.7 million people were in work in the three months to February, with the unemployment rate at 3.9%, its lowest level since 1975. While it should be noted that employment data tends to lag the wider economy, the figures suggest that Brexit has not yet had a significant impact on firms' hiring decisions.

The tightness of the labour market has fuelled strengthening wage growth and this, in turn, has led to increased consumer spending. Retail sales in March recorded year-on-year growth of 6.7%, the highest level since October 2016.

UNCERTAINTY IS THE ONLY CERTAINTY

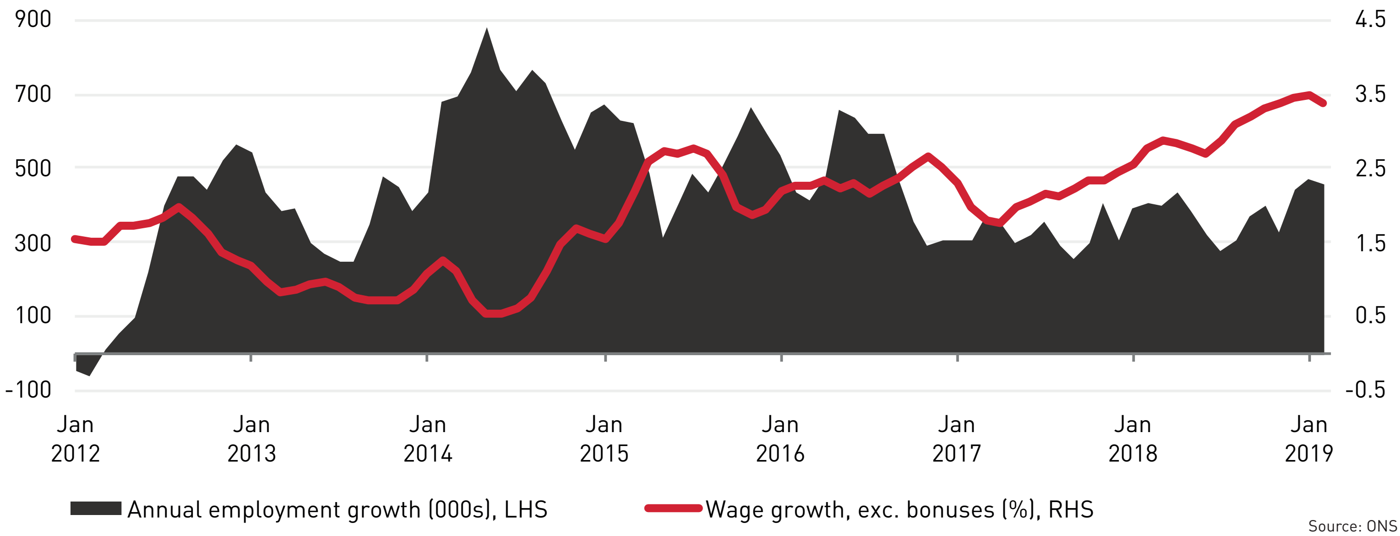
Despite the negative headlines around high street retail, strong consumer spending is actually helping to support the UK economy, partly mitigating the impact of falling business investment due to caution over Brexit. However, business uncertainty is likely to remain heightened well into the second half of the year due to the extended deadline.

Peering through the Brexit fog, there are bright spots in both the UK and global economy. Political uncertainty will dampen growth, but it should not completely derail the UK economy in 2019.

STICK OR TWIST?

Turning to the UK real estate market, the postponement of Brexit has increased the probability that the slow Q1 will set the tone for a year of relatively subdued investment activity. Investors who

UK WAGE GROWTH
AND EMPLOYMENT GROWTH (% Y-O-Y)



Source: ONS

delayed decisions in Q1 in the hope of greater clarity on Brexit will now need to decide whether to act or to continue waiting for several further quarters.

Compared with previous investment slowdowns, there is relatively little distress in the market, so most potential vendors are under no immediate pressure to sell assets. Many will be inclined to continue holding properties, and this will constrain stock levels.

Potential buyers may wait to see if the current uncertainty results in falling prices before making decisions. However, others will seek to cut through the Brexit noise and concentrate on property market fundamentals.

While retail is struggling, the business space markets are proving to be robust and supply is tight. UK property pricing continues to be relatively appealing in a global context and there remains a large volume of international capital that would be attracted to the right buying opportunities.

ALTERNATIVES THE NEW MAINSTREAM

Appetite for alternative property will remain strong, making it an ever more prominent part of the overall investment market. An increasingly diverse range of investors will be drawn to the secure long-term income offered by the living sectors of PRS, hotels, healthcare and student property, and a lack of supply will continue to underpin prices.

The focus on income returns is supported by our latest forecasts, which show that income will be the main driver of total returns in 2019. Capital growth is expected to be negative at an All Property level.

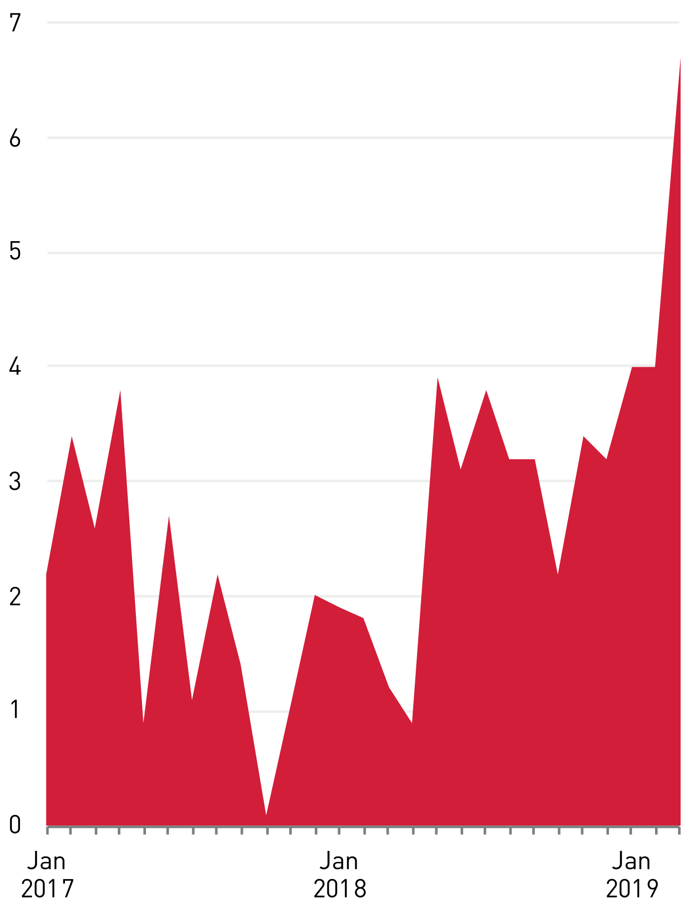
LSH's All Property total return forecast for 2019 has been trimmed to 2.3%. The divergence between the best and worst performing sectors will remain significant, with Industrial total returns expected to be 6.0%, compared with the Retail forecast of -1.0%. However, returns are forecast to pick up in 2020.

VOLUME TO REMAIN SUBDUED

While alternatives will continue to attract demand, the unusually low market shares of the traditional commercial property sectors in Q1 may prove to be anomalous. The early part of Q2 has already seen larger-scale office and retail transactions than the first quarter.

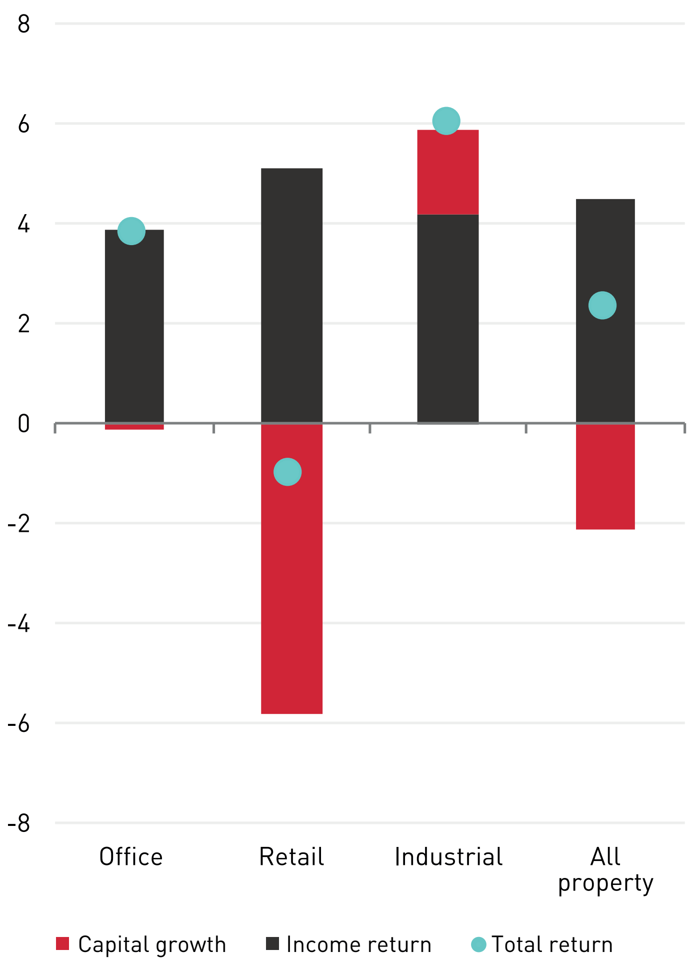
This may be an indication that investors cannot wait indefinitely, and an increased number of large deals may come through over the rest of the year. LSH's view is that overall investment activity will pick up moderately from the Q1 level, while remaining well down on the last two years. We maintain our forecast that the annual investment volume for 2019 will be approximately £50bn, about 20% below 2018. However, the extension of political and economic uncertainty means that there are downside risks to this.

RETAIL SALES VOLUMES
(% CHANGE ON THE SAME MONTH A YEAR EARLIER)



Source: ONS

TOTAL RETURN FORECAST, 2019 (%)



Source: LSH Research, RealFOR

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