# UKIT

Lambert Smith Hampton

## UK INVESTMENT TRANSACTIONS BULLETIN

## Q4 2016


# ADAPTING TO UNCERTAINTY

**Ezra Nahome**
CEO

As the politically tumultuous year of 2016 disappears in the rear view mirror, we move into 2017 certain of one thing; that uncertainty will remain high on the agenda.

But with this becoming as much an international phenomenon as it is domestic, I am confident that the investment community will adapt and even take advantage of the prevailing conditions.

The clear rebound in volume in Q4 is testimony to the enduring appeal of UK property. 2016's total volume for the year was also very respectable in view of last year's events, only marginally undershooting our prediction from 12 months ago.

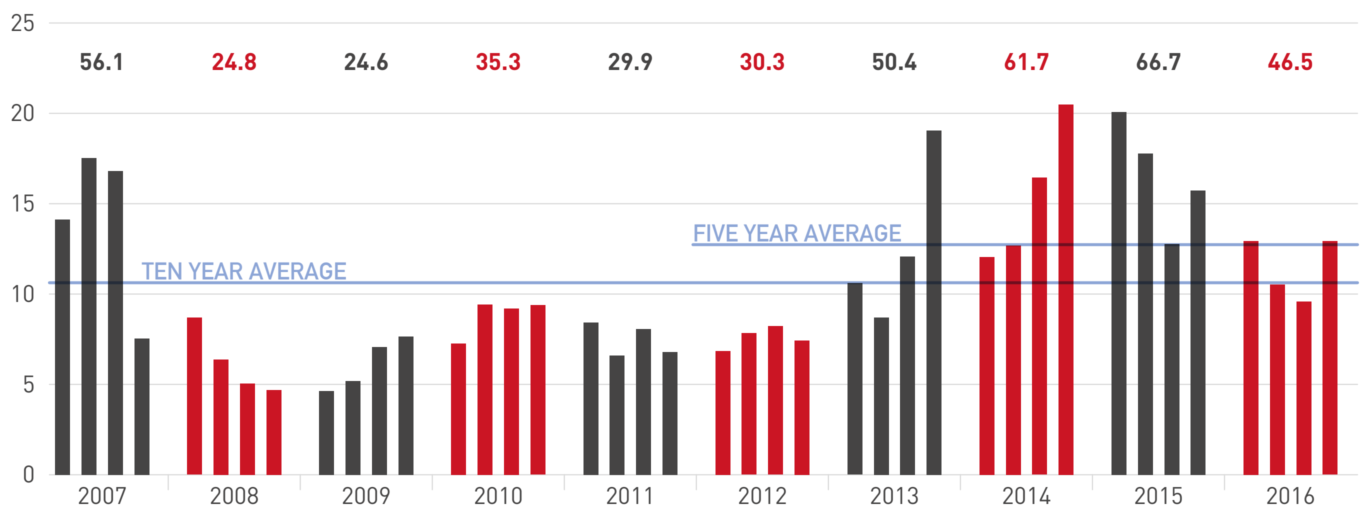
Despite uncertainty over the road ahead, I am cautiously optimistic that activity will improve in 2017. Maintaining liquidity will be vital, however, but I am a reassured by signs that institutions are preparing to come back into the market.

I believe the UK's status as a safe haven is undiminished. Overseas investors will put their increased buying power to good use, and increasingly into the UK regions where there is still yield to be had.

But with yield compression out of the equation, investors will now be relying on driving income to maximise their returns. For the risk averse, prime and long-income assets will remain highly-sought after, but the best opportunities for growth will arguably be found in parts of the secondary market, particularly if conditions in the wider economy remain resilient.

Whatever 2017 has in store, there are sure to be opportunities in the market and I wish you every success over the year ahead.

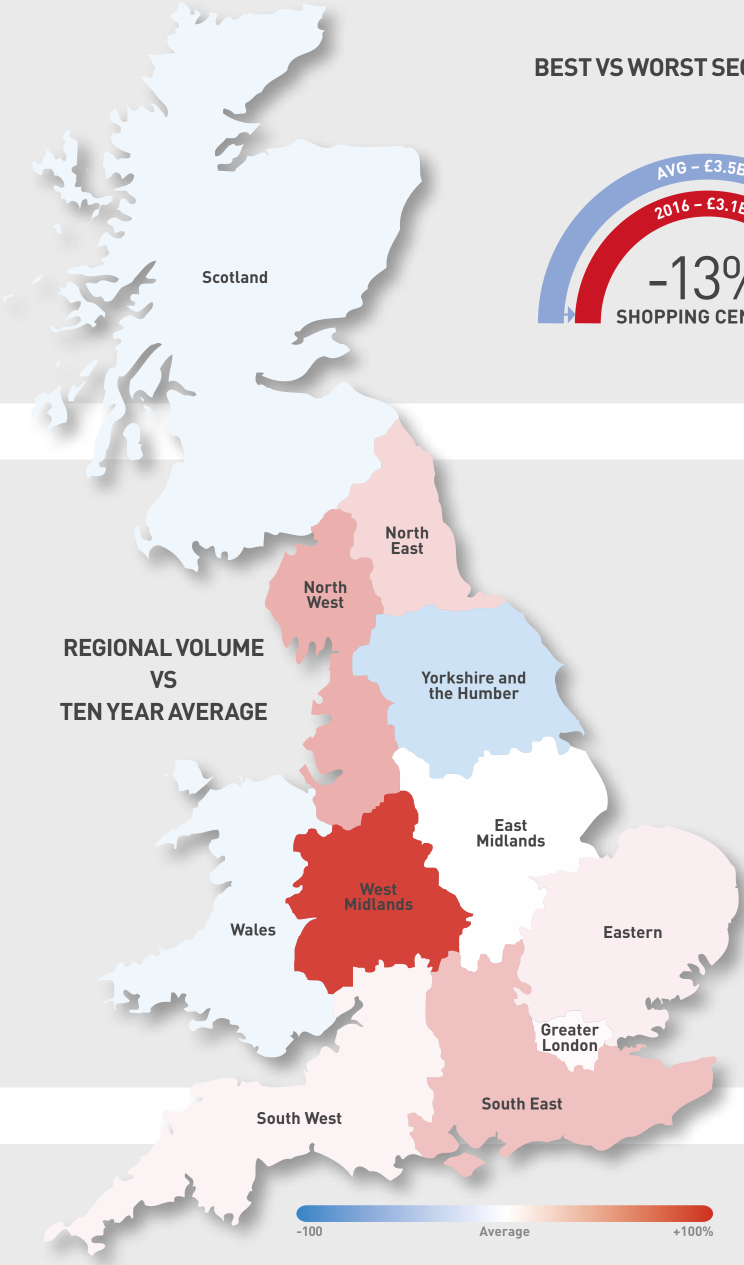
**UK INVESTMENT VOLUME (£BN)**



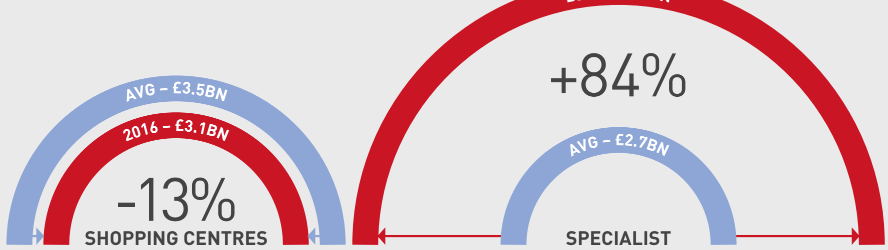

Source: LSH Research, Property Data, Property Archive

# 2016 HIGHLIGHTS

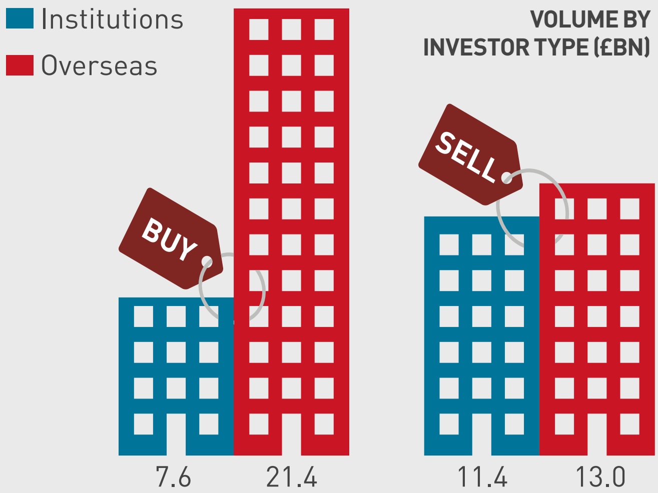
## REGIONAL VOLUME VS TEN YEAR AVERAGE



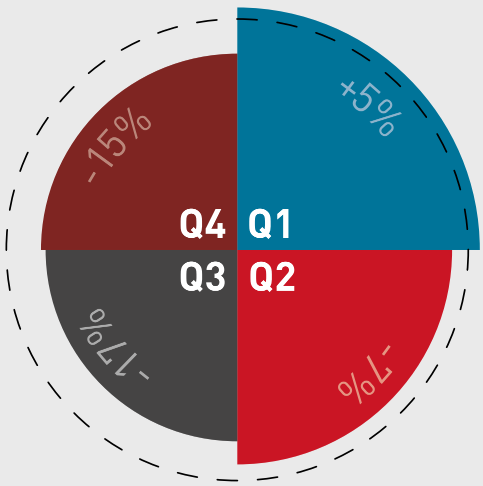

## BEST VS WORST SECTOR FOR VOLUME



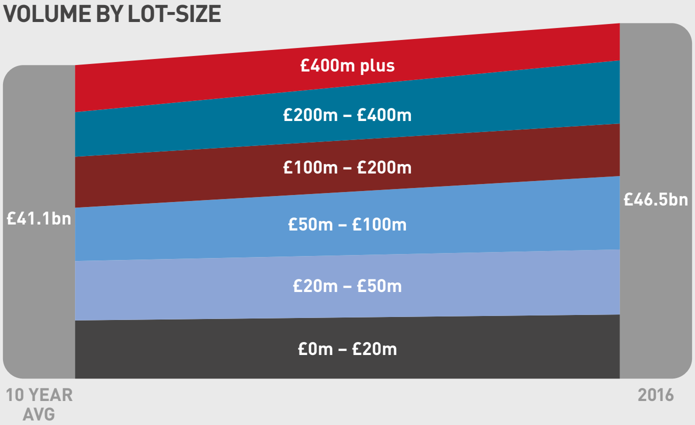

## VOLUME BY INVESTOR TYPE (£BN)




## VOLUME VS FIVE YEAR QUARTER AVERAGE




## VOLUME BY LOT-SIZE



# Q4 ACTIVITY

## Sector focus

2016 ended with a flourish following a quiet period either side of the EU Referendum. Q4's volume took the total for 2016 to a respectable £46.5bn, down 30% on the record of 2015 but only 9% below the five-year annual average.

### Volume and depth of activity increases

Q4 volume rebounded by 31% on Q3 to reach £12.8bn, almost exactly in line with the quarterly average. Moreover, the number of deals in Q4 was up 64% from Q3, indicating resilient activity at the smaller end of the market. This was reflected in the average lot-size, which fell from £25m in Q3 to £20m in Q4.

### Central London offices drive Q4 rebound

Central London offices was key to the uplift, with volume doubling from Q3 to £3.6bn in Q4, its highest quarterly total of the year. Appearing to take advantage of the weak pound, volume was dominated by overseas investors, accounting for over 80% of the total.

Despite the rebound in Q4, Central London office volume for 2016 as a whole was down 28% on the five-year annual average. Meanwhile, however, growing appetite for offices outside the South East saw Rest of UK office volume up 20% on its five-year average.

### Industrial stays in the limelight

Q4 saw £1.7bn worth of industrial assets change hands, the strongest quarter in two years and 39% above the five-year quarterly average. Distribution warehouses was the key performer at £1.1bn, boosted by Blackstone Real Estate's £125m acquisition of the Nevado Portfolio from Clearbell.

Across 2016 as a whole, industrial saw robust volume of £5.4bn. While slightly down on 2015, it was 10% above the five-year average and the only core sector to exceed its trend level. Furthermore, at 12%, industrial's share of the market in 2016 was at its highest in seven years.

### Mixed picture in retail

Total retail volume in Q4 was £2.9bn, up 9% on the five-year average. This was boosted by the largest deal of the quarter, APG's £570m acquisition of a 75% stake in St James Quarter shopping centre, Edinburgh from Henderson. In contrast, shops had a subdued quarter, down 6% on the five-year average.

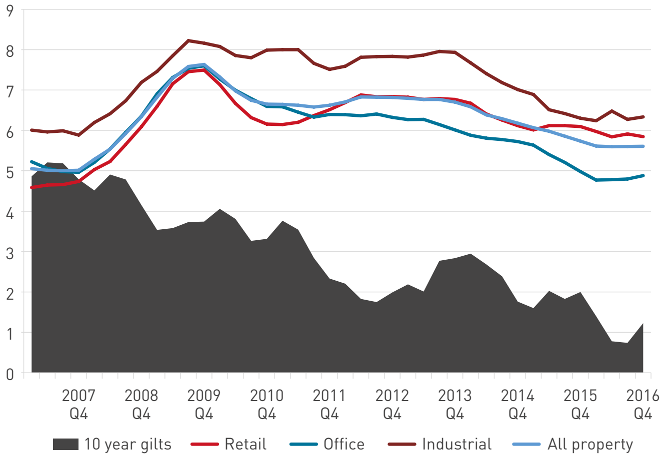
Yet across the year as a whole, shops attracted the lion's share of retail volume at £4.9bn, up 15% on the five-year average, although heavily skewed by portfolio and London deals. At £10.4bn, total retail volume for 2016 was marginally below trend, largely off the back of shopping centres, which was 19% below the five-year average.

### TRANSACTION VOLUME (£BN)

| SECTORS | Q4 2016 | VS Q3 2016 | VS Q4 2015 | VS 5 YEAR AVG |
|---|---|---|---|---|
| Shops | £1.01 | -47% | -4% | -6% |
| Shopping Centres | £1.16 | 875% | 83% | 22% |
| Retail Warehouse | £0.72 | 22% | -15% | 15% |
| **ALL RETAIL** | **£2.90** | **11%** | **14%** | **9%** |
| Central London Offices | £3.63 | 104% | -21% | -4% |
| Rest of South East Offices | £0.47 | 40% | -66% | -24% |
| Rest of UK Offices | £0.55 | 3% | -49% | -18% |
| Office Parks | £0.17 | -63% | -64% | -64% |
| **ALL OFFICE** | **£4.82** | **55%** | **-36%** | **-13%** |
| South East Industrial | £0.29 | 61% | -7% | 46% |
| Rest of UK Industrial | £0.34 | 23% | -29% | -8% |
| Distribution Warehouse | £1.06 | 103% | 91% | 64% |
| **ALL INDUSTRAL** | **£1.69** | **72%** | **26%** | **39%** |
| Hotels & Leisure | £1.22 | 83% | -44% | 10% |
| Specialist | £1.21 | -33% | 152% | 8% |
| Mixed-use (single assets & portfolios) | £1.00 | 63% | -48% | -12% |
| **ALL PROPERTY** | **£12.84** | **31%** | **-20%** | |

Source: LSH Research, Property Archive, Property Data

## ROLLING ANNUAL TRANSACTIONAL YIELD & 10-YEAR GILTS (%)




Source: LSH Research, Experian

### Momentum in Alternatives continues

At £2.4bn, Q4 investment in the alternative sectors was up 9% on the five-year quarterly average. Hotel & leisure volume in particular was healthy, boosted by Muirgold's £300m purchase of DoubleTree by Hilton, London from Blackstone Real Estate.

In the shadow of 2015's outstanding year for alternatives, activity in 2016 was less buoyant but at £9.1bn was still 4% above the five-year average. This included the largest UK commercial property deal of the year, London & Regional's £575m acquisition of the Atlas hotel portfolio from Lone Star in May, 2016.

### Transaction yield stabilises

The All Property transaction yield was 5.65% in Q4, showing no movement on Q3's level and indicative of a stabilisation of average property values in the final quarter of 2016. This is echoed on the valuation side, with IPD's All Property net initial yield remaining constant at 5.3% during the last three months of the year.

### Prime yields see little change

Similarly, at the prime end of the market, yields were also broadly stable during Q4 across the majority of sectors, underlining the ongoing strength of demand for income.

### Risk appetite varies

Despite stability in yields at the All Property level, Q4 arguably showed a change in risk appetite, shown by diverging movements in the prime and transaction yield for a number of sectors.

For example, while the average transaction yield for shopping centres moved in by 80 bps, the prime yield for sub-regional shopping centres was the only sector to soften, moving out by 25 bps. This suggests that investors were focusing on lower risk assets.

By the same token, the industrial transaction yield moved out during the final quarter, following its record low in Q3. Yet industrial is the one core sector where market sentiment around prime yields is hardening. This disparity in yield movements suggests that appetite for risk is most prevalent in the industrial sector.

## Q4 2016 YIELDS

| SECTOR | Transaction yields | | | Prime yields | | | YIELD SENTIMENT |
|---|---|---|---|---|---|---|---|
| | Q4 2016 | 3 MONTH MOVEMENT (BPS) | 12 MONTH MOVEMENT (BPS) | Q4 2016 | 3 MONTH MOVEMENT (BPS) | 12 MONTH MOVEMENT (BPS) | |
| Shops | 4.95% | ▲ 50 | ▲ 16 | 4.00% | ◀▶ | ◀▶ | ◁▷ |
| Shopping Centres | 5.80% | ▼ -80 | ▼ -107 | 5.75%* | ▲ 25 | ▲ 50 | △ |
| Retail Warehouse | 6.41% | ▼ -2 | ▲ 22 | 4.50% | ◀▶ | ▲ 25 | – |
| **ALL RETAIL** | 5.81% | ▼ -19 | ▼ -25 | – | – | – | – |
| Central London Offices | 4.07% | ▼ -37 | ▲ 39 | 3.50% | ◀▶ | ▲ 25 | ◁▷ |
| Rest of South East Offices | 5.82% | ▼ -15 | ▼ -2 | 5.00% | ◀▶ | – | ◁▷ |
| Rest of UK Offices | 7.52% | ▲ 147 | ▲ 143 | 5.00% | ◀▶ | – | ◁▷ |
| Office Parks | 6.45% | ▲ 142 | ▼ -108 | 6.00% | ◀▶ | – | ◁▷ |
| **ALL OFFICE** | 4.93% | ▲ 2 | ▲ 33 | – | – | – | – |
| South East Industrial | 6.33% | ▲ 97 | ▲ 41 | 4.75% | ◀▶ | ▲ 25 | ▽ |
| Rest of UK Industrial | 7.54% | ▲ 149 | ▲ 74 | 6.00% | ◀▶ | ◀▶ | ▽ |
| Distribution Warehouse | 5.79% | ▲ 37 | ▼ -73 | 4.25% | ◀▶ | | ▽ |
| **ALL INDUSTRAL** | 6.50% | ▲ 96 | ▲ 24 | – | – | – | – |
| Hotels & Leisure | 5.70% | ▼ -24 | ▲ 47 | 4.75% | ◀▶ | ◀▶ | ◁▷ |
| Specialist | 5.35% | ▼ -45 | ▼ -58 | 4.75%** | ◀▶ | ◀▶ | ◁▷ |
| Mixed-use (single assets & portfolios) | 6.24% | ▼ -154 | ▲ 8 | – | – | – | – |
| **ALL PROPERTY** | 5.65% | ◀▶ 0 | ▲ 3 | – | – | – | – |

Source: LSH Research, Property Archive, Property Data

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

# Regional focus

Alongside Central London offices, the rebound in Q4 also reflected strong activity in the UK's regional markets. Furthermore, across 2016 as a whole, activity in the regions was healthy with annual volume up 8% on the five-year average, while London was down 16%.

**Regions drive Q4 rebound**

At £5.3bn, volume for single-asset deals in the UK regions was up 81% on Q3 and 31% above the five-year quarterly average. This was boosted by the largest deal of the year, St James Quarter in Edinburgh, which also took Scotland's Q4 volume to its strongest quarter in two years.

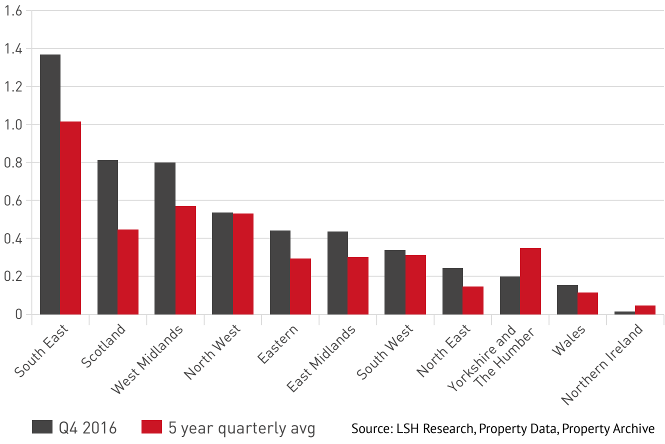
Given relatively stiff competition in the capital, there has been a material increase in overseas investor appetite for regional assets. During 2016 as a whole, overseas investors purchased £5.3bn worth of single-asset deals outside of London, the highest on record.

**Strong end to the year for London**

At £5.9bn, Q4 volume in Greater London was up 47% on Q3 and the strongest quarter of the year for the capital. However, as mentioned, this was largely driven by Central London offices which accounted for 62% of Greater London volume.

This brought 2016 volume for Greater London to £19.7bn, markedly down on 2015's record year and 16% below the five-year average. UK institutions were most notably absent

### REGIONAL INVESTMENT VOLUME (£BN)




Source: LSH Research, Property Data, Property Archive

from the market, with their investment into the capital down 56% on the five-year annual average.

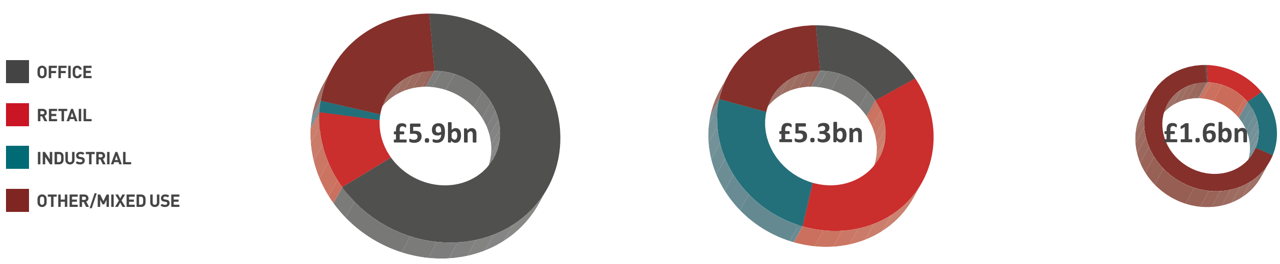
**Portfolios drag on Q4 volume**

At £1.6bn, portfolio volume was remarkably low in Q4, the lowest quarterly amount in over three years. While volume was 43% below average, the number of portfolio deals was actually above the norm, reflecting an absence of major deals as opposed to quiet activity.

Having been a key factor behind 2015's record year for volume, portfolio volume in 2016 as whole was less than halve its 2015 level, at £4.4bn. With strong overseas demand for large lot-sizes continuing, this largely reflects as a lack of suitable stock on the market.

### LONDON AND REGIONAL BREAKDOWN (£BN)

GREATER LONDON | UK REGIONS | PORTFOLIOS




| | GREATER LONDON | UK REGIONS | PORTFOLIOS |
|---|---|---|---|
| VS Q3 2016 | 47% | 81% | -43% |
| VS Q4 2015 | -14% | 16% | -65% |
| VS 5 YEAR QTY AVG | 0% | 30% | -43% |

Source: LSH Research, Property Data, Property Archive

# Buyers and sellers

While UK institutions were very quiet in Q4, overseas investors have seized the opportunity of the weak pound and helped to fill the void, particularly in the UK regions.

### Record sell-off from the institutions

Institutional investors were net-sellers to the tune of £2.2bn in Q4, the highest ever recorded in a single quarter. This reflects the requirement among UK Retail funds to meet redemptions alongside limited purchasing activity in Q4.

This trend was seen across 2016 as a whole, largely down to institutions' absence from the London buying pool. They purchased £1.7bn of assets in the capital, minimal when compared to £6.2bn the previous year.

### Record for overseas investment into the regions

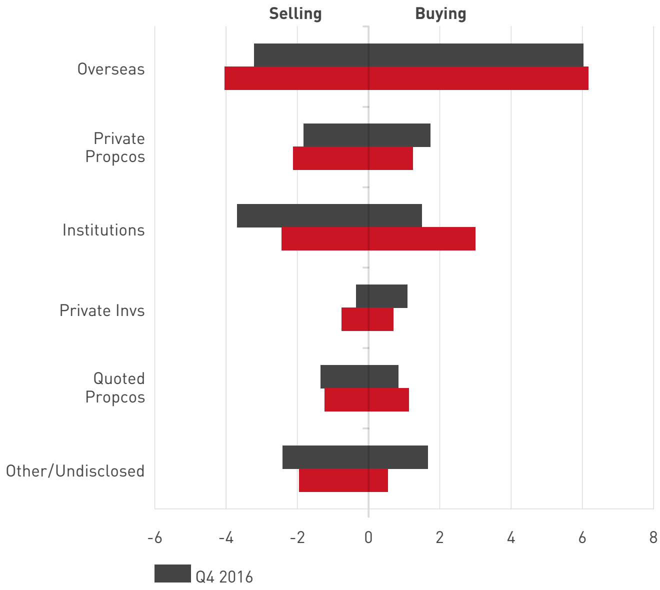
The uplift in activity in Q4 was partly down to overseas investors taking advantage of sterling's devaluation, purchasing £6.0bn of real estate, the highest total of any quarter in 2016. Q4 also saw a record of £1.5bn of overseas investment in regional single-asset deals.

This trend was seen across 2016 as a whole, with overseas' investment into regional single-asset deals at a record £5.3bn. Mapletree Investments' £563m acquisition of Green Park, Reading was the largest overseas deal in the regions during 2016.

### Active quarter for private investors

At £1.1bn, private investors were also notably active in Q4, their strongest volume in six quarters. In terms of net-investment, at £0.7bn, Q4 was the highest level since Q1 2004. This was boosted by Muirgold's £300m purchase of DoubleTree by Hilton hotel in London from Blackstone Real Estate.

#### VOLUME BY INVESTOR TYPE (£BN)



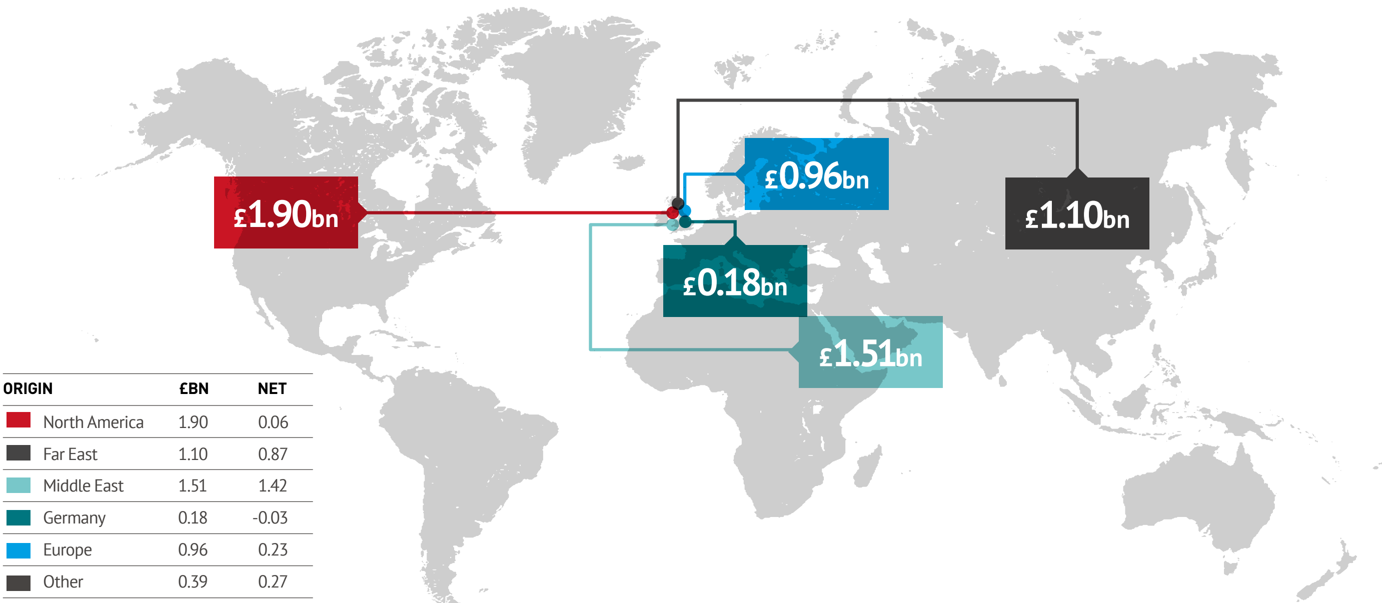

Source: LSH Research, Property Data, Property Archive

### Local authority investment continues apace

Following the emphatic arrival of local authority buyers to the market in Q3, activity continued in Q4, taking advantage of the access to cheap finance. With £0.6bn of acquisitions during the quarter, it closely followed Q3's record of £0.7bn.

The largest local authority deal in Q4 was Surrey Heath Council's £86m (NIY 5.9%) purchase of The Mall shopping centre, Camberley from Capital & Regional; while Spelthorne Borough Council's £360m (NIY 4.5%) acquisition of The BP International Centre in Q3 was the largest ever purchase by a local authority.

#### Q4 2016: GLOBAL INVESTMENT FLOWS INTO UK (£BN)




| ORIGIN | £BN | NET |
|---|---|---|
| North America | 1.90 | 0.06 |
| Far East | 1.10 | 0.87 |
| Middle East | 1.51 | 1.42 |
| Germany | 0.18 | -0.03 |
| Europe | 0.96 | 0.23 |
| Other | 0.39 | 0.27 |

Source: LSH research, Property Data, Property Archive

# OUTLOOK

2016 will go down as one of the most politically turbulent years in a generation, not only domestically in the wake of the UK's exit vote from the EU, but also internationally.

## Uncertainty as the new norm?

After a long period of obfuscation, Theresa May has finally set out her stall over the UK's position in advance of triggering Article 50, scheduled in March. The stance is one of a 'clean-break' from the single market, although the UK's eventual trading relationship with the EU could be far closer when Brexit does become a reality.

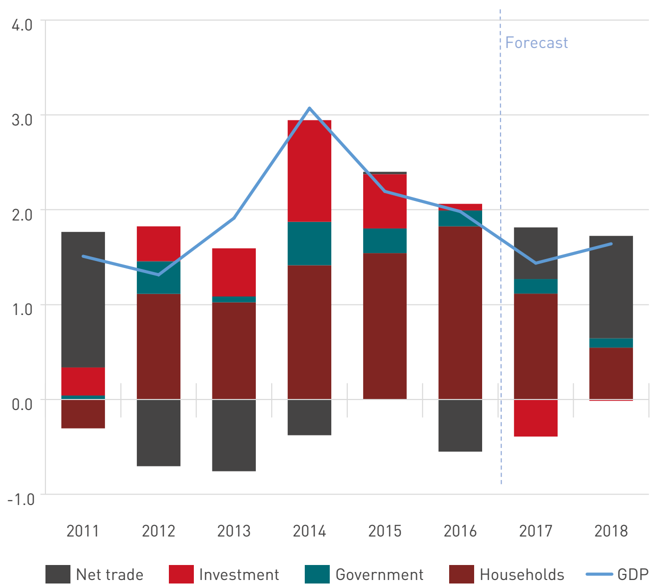
Perhaps there is some comfort from the fact that uncertainty is rising up the agenda in other western economies. In Europe, 2017 brings elections in Holland, France and Germany, all with the potential to shake the prevailing establishment. In an increasingly 'post-truth' world, the UK's vote for Brexit appears less of an anomaly with each passing month.

## Economy enters 2017 on front foot

Last year's events have done little to disrupt momentum in the real economy. The first estimate of UK GDP growth for Q4 2016 stands at 0.6%, taking growth for 2016 as whole to a respectable 2.0%. Notably, this is closely in line with the consensus forecast from a year ago, and sees the UK outperform all other major economies in the G7.

Perhaps we should not be too surprised by the apparent resilience in the economy. Aside from a significant devaluation of sterling, as yet Brexit is nothing more than an electoral preference. The road to Brexit is sure to have its twists and turns and, with the long term implications far from certain, adopting a 'business as usual' approach appears the most rational response so far.

### CONTRIBUTIONS TO UK GDP GROWTH (%)




Source: ONS/Experian

The apparent resilience is also being driven by the dominant services sector, including strong growth in retail trade which expanded by 5.0% during 2016. While the industrial sector has been patchy during 2016, sterling's devaluation is expected to boost the competiveness of UK exports and drive growth in the coming two years.

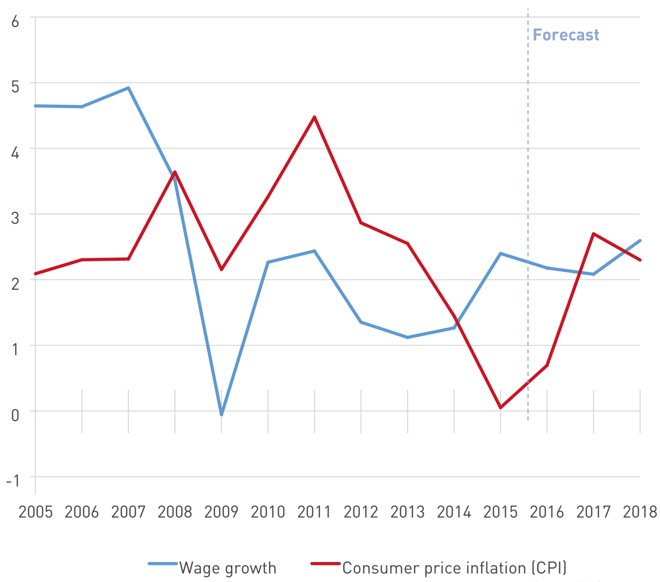
## Rising inflation is the main downside risk

Rising inflation, or rather 'reflation', is one clear consequence of sterling's devaluation, and this poses the main downside risk over the coming 12 months. A combination of rising import costs and resurgent global oil prices is already feeding through to consumer prices, with CPI rising from 0.5% last June to a two-year high of 1.6% in December.

But the key question is just how high will inflation go? The consensus and major forecasting houses are pointing at inflation peaking at around 3% during 2017, a level which the Bank of England is likely to overlook in order to support growth. In 2012, CPI moved to beyond 5% yet the Bank of England was unmoved on the interest rate.

Nonetheless, with inflation set to outstrip wage growth, economic growth is expected to moderate to 1.5% in 2017. Reassuringly, however, the global economic outlook is much improved from a year ago, with concerns over China and the emerging markets subsiding alongside expectations of major fiscal stimulus forthcoming in the US economy.

### WAGES VS INFLATION (%)




Source: ONS, Experian

# Property market outlook

The year ahead be will be challenging for the investment community but certainty not without opportunity. With yield compression largely out of the equation, strategies aimed around driving income growth will be key to maximising returns.

### Strong demand for income generation

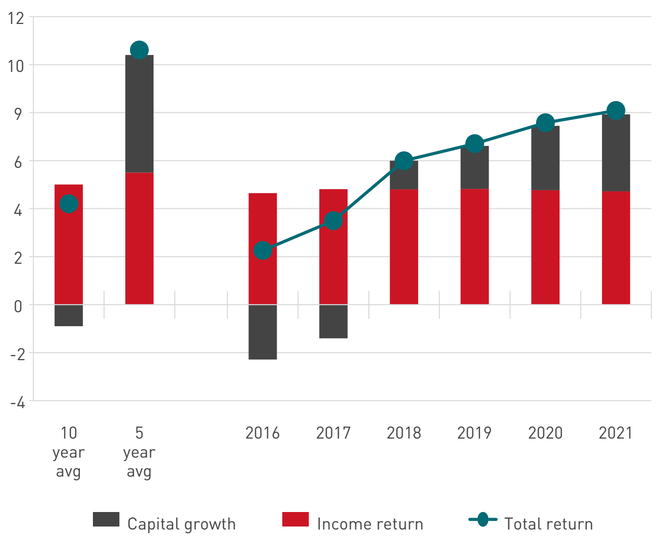
Reflecting greater risks to the downside from 12 months ago, core investors will redouble their focus on securing income, such as long-leased assets to sound covenants. While current sentiment suggests prime yields will hold at their current level, an ongoing weight of global capital and benefits from the currency arbitrage could yet put further upward pressure on prices for the very safest assets.

### Sound fundamentals

The investment rationale for UK property remains sound relative to other asset classes. While bond yields have ticked up in recent months on the back of rising inflation expectations, the Monetary Policy Committee is unlikely to react with an interest rate hike without evidence of domestic capacity constraints emerging in the economy.

With expectations that the bank rate could persist at or near its record low for another two years, property's substantial yield spread over gilts is unlikely to be materially affected. At the time of writing, the spread between the All Property transaction yield and 10-year gilt yields stands at a substantial 450bps, with headroom for gilts to climb further before directly compromising property values.

**TOTAL RETURN FORECAST VS HISTORIC AVERAGE (%)**




Source: MSCI, LSH

### Modest returns in 2017

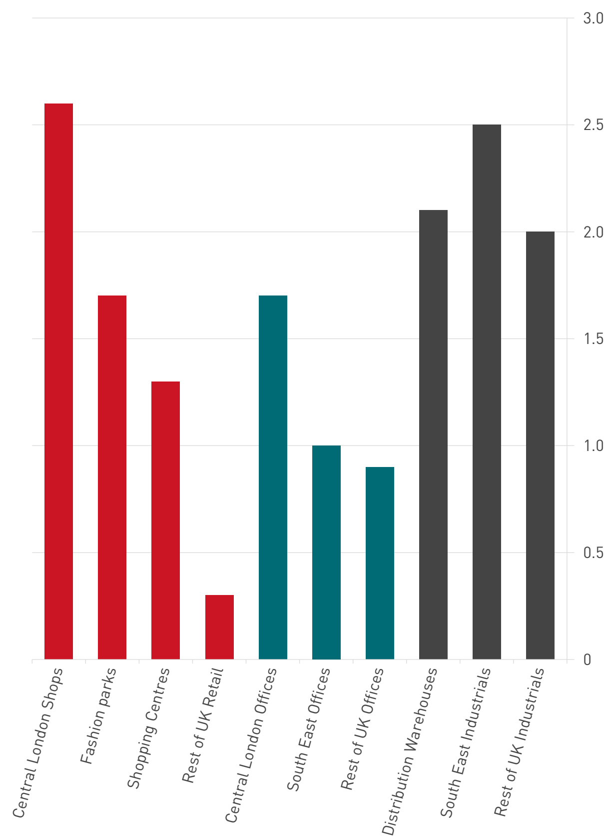
Regardless of the Referendum result, the yield compression which characterised 2014/15 was never likely to be sustained. At the All Property level, total returns in 2017 are expected to be modest, albeit positive, before recovering to more respectable levels in the years thereafter. Our All Property total return forecast is 3.5% for 2017, with the income return offset by a slight fall in capital values.

However, the impact on values will be largely borne by weaker secondary assets. Positively, a thinner market for this type of product may provide an opening for opportunity-seeking investors who are willing to trade off the uncertainty over the economic outlook with the relatively tight supply conditions in the occupier markets.

### Change to the rental cycle

One expected consequence of the Brexit vote is an alteration of the rental growth cycle from its original pre-Referendum path. Notwithstanding significant variation between sectors, All Property rental growth is set to flatline in 2017, as occupiers become more risk averse. However, with supply remaining constrained, a rebound in occupier confidence after 2017 may postpone growth later into the cycle than originally forecast.

**RENTAL GROWTH FORECAST 2017 TO 2021 (% P.A.)**



# 2017 PREDICTIONS

While 2017 is set to be a challenging year, there are undoubtedly opportunities in the market. In keeping with UKIT Q4 tradition, here are our eight key predictions for the year ahead.

1

**Investment volume to improve on 2016**

Total investment volume in 2017 is expected to surpass the annual average and exceed 2016's £46.5bn. Overseas buyers, especially from the Far East, will continue to exploit the currency position and invest in quality UK assets. Ongoing liquidity in the market will be crucial, however, and institutional investors have a key role to play in bringing stock to the market and reinvesting their capital.

2

**Industrial set to outperform**

Benefiting from both acute shortages of supply and the ongoing structural shift to ecommerce, UK industrial and logistics is well placed to outperform the wider market once again in 2017 with a forecast annual return of 5.7%. Alongside its enduring income qualities, the sector's rental growth prospects remain firmly in positive territory despite being pared back post-Referendum.

3

**Resurgent institutions focus on alternatives**

After a tumultuous year, particularly for the retail funds, there are indications that institutional investors are readying themselves to re-enter the market. A focus on both security of income and yield will see strong funding interest into alternatives. Sectors that are relatively insulated from the short-term economic fluctuations by structural change such as build to rent, healthcare and retirement living, are expected to be among the main targets.

4

**Speculative development to moderate**

2017 will be a testing year for the construction industry. Developers will generally be more cautious to kick-start new-build projects speculatively in light of higher potential void risks, while sterling's devaluation will feed through into both higher costs for imported building materials and potential labour constraints, as the earning power of foreign EU construction workers is eroded.

5

**Office refurbishment to increase**

In 2018, energy regulations will come into force which will make poorly rated building unlettable. While new build development will slow, 2017 is expected to see a significant rise in refurbishments, as landlords seek to address the legislation and preserve asset value. Well-advised landlords who are able to retain their tenant in situ and minimise disruption stand to benefit most.

6

**Local authority buyers to remain active**

A need to generate revenue spurred the emphatic arrival of local authorities to the market in 2016. While their sources of finance may not be sustainable in the medium to long term, the trend is expected to remain in place over the coming year with more council buyers entering the market, often buying outside their jurisdictions.

7

**Resilience in regional office markets**

Occupier activity and prime headline rental levels are expected to be resilient in the regional markets during 2017, certainly compared with London. The impact of the business rates revaluation is at worst minimal for the regional markets, while painful rises in many of London's sub-markets may tempt occupiers in the capital to consider partly relocating into more affordable UK cities. Furthermore, take-up in the core regional markets will be boosted by major planned government-led moves.

8

**Food and Beverage growth channelled into regional cities**

Overall, 2017 is set to be a challenging year for the high street, affected by both the structural change towards ecommerce and an anticipated fall in consumer spending. While record tourist numbers will support spend in Central London, the wider impact of the fall in the pound will be to weaken spending power, as imported inflation eats into real wages.

However, one clear area of opportunity in 2017 is capturing the rapid growth of food and beverage outlets. Increasing consumer demand for food offerings which are both convenient and healthy is driving UK-wide expansion among operators. The opportunity here will be greatest in appropriately-sized units within established business districts.

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