Lambert Smith Hampton

PAUSE

UKIT Q219

UK INVESTMENT TRANSACTIONS BULLETIN

Q2 VOLUME SLUMPS TO SIX-YEAR LOW

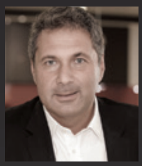
LARGE LOTS & PORTFOLIOS HIT HARDEST

£1BN+ DEAL FLATTERS OFFICE VOLUME

OVERSEAS INVESTORS ARE ONLY NET BUYERS

INSTITUTIONS NET SELLING: £831M

AVERAGE TRANSACTION YIELD UP 22BPS



Ezra Nahome
CEO

Brexit's extension out to October has clearly weighed heavily on appetite to do deals over the past few months. Amid all the uncertainty, the market has effectively paused.

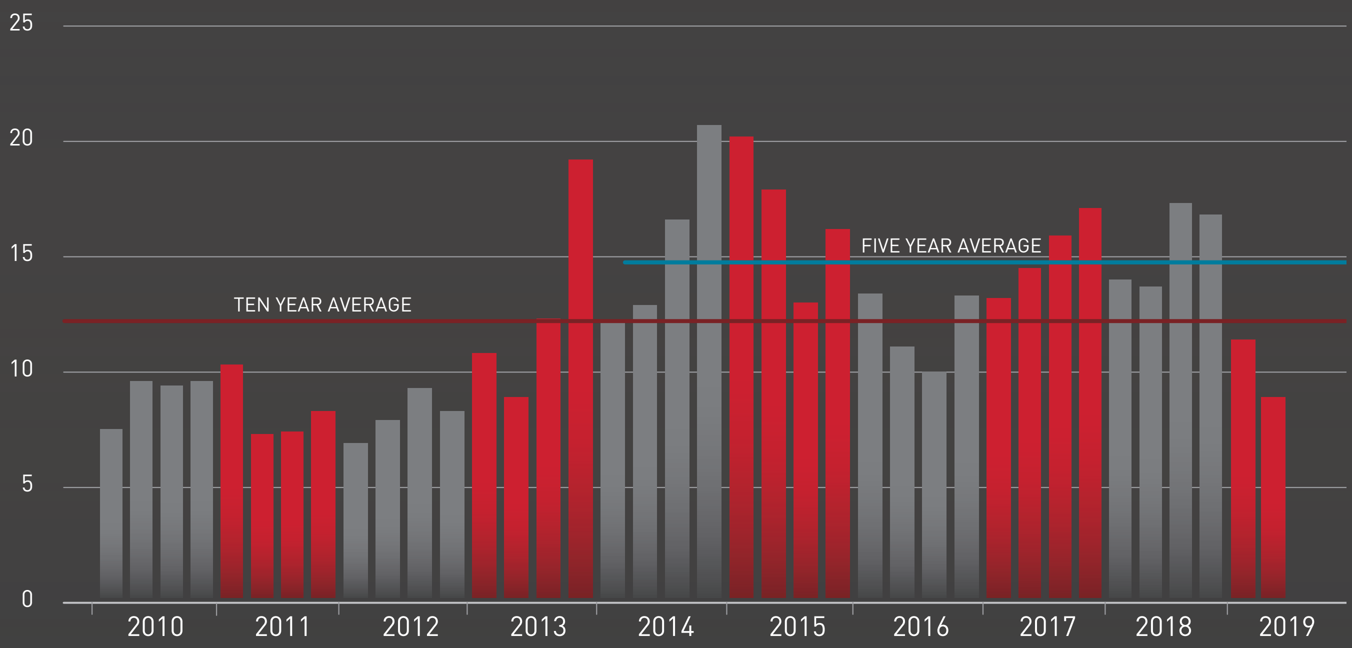
The fundamentals of investing in UK real estate remain sound, but uncertainty over the Brexit outcome and a lack of distress in the current market is stifling appetite among buyers and vendors alike. However, if the outflows from the UK funds turn from a trickle into something more substantial, this could trigger a wave of selling, as it did in 2016.

While there is no shortage of capital in the market looking to invest in secure income, the climate of uncertainty has proven detrimental to the market for secondary product. The buyers are out there, although there is caution around current pricing levels, while vendors have little incentive to sell below current valuations.

As the UK's newly appointed prime minister, all eyes now turn to Boris Johnson. Only time will tell whether his tougher rhetoric around renegotiating Brexit will translate into a result that both the electorate and markets can collectively approve of. Time is also in short supply for the new prime minister to achieve his desired Brexit by the end of October.

But a resolution to Brexit, one way or the other, will be absolutely vital in restoring activity to a level that better reflects the attractive properties of UK real estate. Volumes are set to remain subdued until clarity emerges, after which we can expect a significant release of pent-up demand and a rebound in transactional activity.

UK INVESTMENT VOLUME (£BN)



Source: LSH Research, Property Data, PMA

SECTOR FOCUS

BREXIT IMPASSE

The extension of Brexit to October weighed heavily on investment activity during Q2, particularly at the larger end of the market, while no sector was really immune from the climate of uncertainty.

Total volume slumped to a six-year low of £8.8bn in Q2 2019, down 22% on Q1's already subdued level and 40% below the five-year quarterly average. The impasse weighed on the larger end of the market; the total number of deals in Q2 was 15% below the five-year quarterly average while the number of deals in excess of £20m was 36% below trend.

MEGA DEAL FLATTERS OFFICES

With volume of £3.9bn in Q2, offices appeared the most resilient of the three core sectors, standing 33% below average. On face value, Central London office volume of £2.8bn was relatively respectable, rebounding by 53% on Q1's ten-year low, but this was flattered by Citigroup's long-mooted £1.1bn (4.23% NIY) purchase of 25 Canada Square, E14 from AGC Equity Partners.

Elsewhere, a lack of large deals weighed heavily on office volumes across the rest of the UK; Q2 saw only three office transactions in excess of £50m outside Central London. The largest by far was Gulf Islamic Investments' £139m purchase of the Lewis Building, Birmingham, albeit the deal had been largely agreed in late 2018.

LIVING TURNS LIFELESS

Having given some respectability to total volume in Q1, the Living sectors (student accommodation, PRS, hotels, healthcare) actually endured the largest fall from grace in Q2, with volume tumbling by 70% from Q1 to a three-year low of £1.6bn. The sharp fall is down to the typically large lot-sizes associated across the Living sectors and a lack of stock in Q2.

Hotels & leisure saw the weakest volume of any property sector relative to trend. Following a strong run of activity in recent years and record high volume of £2.7bn in Q1, volume sank abruptly to a seven-year low of £459m in Q2, 70% below the five-year quarterly average.

Reflecting more resilient sentiment towards the private residential sector and appetite for forward funding, build to rent accounted for six of the ten largest Living deals in Q2. However, the largest deal in the Living arena was Singapore Press Holdings' £134m purchase of a student accommodation portfolio of 1,243 beds.

Q2 2019 INVESTMENT VOLUME (£BN)

VOLUME VS 5YR QTY AVG

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

SECTOR	Q2 2019	Q1 2019	Q4 2018	Q3 2018	VS Q1 2019 (%)
Shops	0.92	0.63	0.81	0.67	47%
Shopping Centres	0.27	0.05	0.40	0.04	468%
Retail Warehouse	0.31	0.41	0.24	0.77	-24%
ALL RETAIL	**1.50**	**1.08**	**1.45**	**1.47**	**39%**
Central London Offices	2.79	1.83	4.27	4.50	53%
Rest of South East Offices	0.34	0.36	0.46	0.91	-5%
Rest of UK Offices	0.65	0.34	1.51	0.97	91%
Office Parks	0.20	0.21	0.26	0.40	-3%
ALL OFFICE	**3.99**	**2.73**	**6.49**	**6.77**	**46%**
South East Industrial	0.11	0.28	0.39	0.31	-58%
Rest of UK Industrial	0.22	0.41	0.83	0.96	-48%
Distribution Warehouse	0.52	0.84	1.08	0.92	-38%
ALL INDUSTRIAL	**0.85**	**1.53**	**2.29**	**2.19**	**-44%**
Hotels & Leisure	0.46	2.68	1.00	1.24	-83%
Student, Healthcare, PRS	1.18	2.59	2.26	3.23	-55%
ALL LIVING	**1.64**	**5.26**	**3.27**	**4.47**	**-69%**
Mixed-use & other	0.80	0.65	2.83	2.13	24%
ALL PROPERTY	**8.78**	**11.26**	**16.33**	**17.04**	**-22%**

Source: LSH Research, Property Data, PMA

Q2 2019 YIELDS

	TRANSACTION YIELDS			PRIME YIELDS			YIELD SENTIMENT
SECTOR	Q2 2019	3 MONTH MOVEMENT (BPS)	12 MONTH MOVEMENT (BPS)	Q2 2019	3 MONTH MOVEMENT (BPS)	12 MONTH MOVEMENT (BPS)	
Shops	3.39%	▼ -125	▼ -75	4.75%	▲ 25	▲ 25	△
Shopping Centres	7.44%	N/A	▲ 50	6.75%*	◄►	▲ 75	△
Retail Warehouse	7.74%	▲ 164	▲ 199	6.00%	▲ 50	▲ 125	△
ALL RETAIL	6.36%	▲ 15	▲ 62	-	-	-	-
Central London Offices	4.38%	▼ -8	▲ 7	3.75%	◄►	▲ 25	◁▷
Rest of South East Offices	5.91%	▲ 29	▲ 36	4.75%	◄►	▼ -25	◁▷
Rest of UK Offices	6.32%	▼ -34	▼ -8	4.75%	◄►	◄►	◁▷
Office Parks	6.10%	▼ -138	▼ -115	5.25%	◄►	◄►	◁▷
ALL OFFICE	5.14%	▼ -6	▲ 10	-	-	-	-
South East Industrial	5.02%	▲ 95	▲ 72	3.75%	◄►	◄►	◁▷
Rest of UK Industrial	7.38%	▲ 89	▲ 61	4.75%	◄►	◄►	◁▷
Distribution Warehouse	5.17%	▲ 14	▲ 1	3.75%	◄►	◄►	◁▷
ALL INDUSTRIAL	5.46%	▲ 68	▲ 47	-	-	-	-
Hotels & Leisure	5.05%	▲ 15	▼ -370	4.25%	◄►	◄►	◁▷
Student, Healthcare, PRS	5.59%	▲ 113	▲ 31	5.00%**	◄►	◄►	▽
ALL LIVING	5.37%	▲ 68	▼ -166	-	-	-	-
Mixed-use & other	5.51%	▼ -25	▲ 44	-	-	-	-
ALL PROPERTY	5.70%	▲ 22	▲ 25	-	-	-	-

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

Source: LSH Research, Property Data, PMA

INDUSTRIAL MARKET REMAINS BUSY

Industrial was the most actively traded sector against trend in Q2, with the number of deals exactly in line with the five-year trend. As with other sectors, subdued volume reflected limited activity at the larger end of the market. For the first time in seven years, Q2 saw only one deal in excess of £50m; Sports Direct's £120m sale and leaseback of its HQ at Brook Park, Mansfield to a Malaysian fund.

RETAIL VOLUME RECOVERS. SLIGHTLY

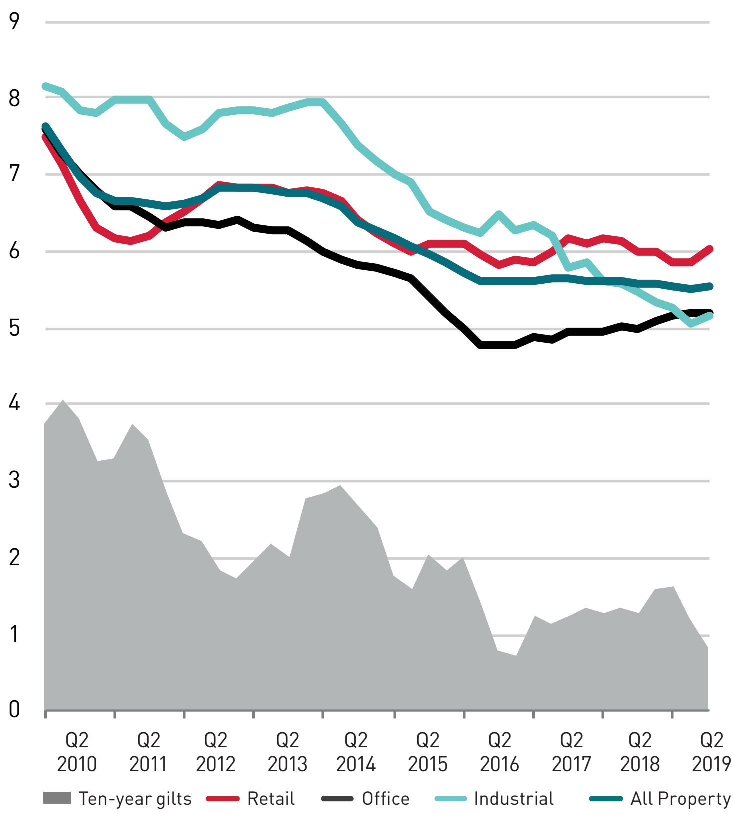
Retail continued its subdued run, with volume recovering slightly from an all-time low in Q1 to £1.5bn in Q2. While shopping centre volume remains moribund, shops came closest of any sub-sector in the market to a par performance. Shop volume of £920m in Q2 was only 14% below trend, underpinned by Realty Income Corporation's £420m (5.00% NIY) purchase of the Sainsbury's portfolio.

YIELDS ON THE RISE

Having stood at an 11-year low in Q4 2018, the All Property average transaction yield has since moved out in each of the past two quarters to stand at a four-year high of 5.70% in Q2. While valuations reveal a slight softening of prices for secondary product in some sectors, the 22 basis point outward movement in Q2 better reflects the lack of prime, secure income stock traded during the quarter.

Ongoing strong demand for secure income continues to support pricing at the prime end of the market. As ever, reflecting weak sentiment toward the occupier market prospects, retail remains the clear exception. While notional prime shopping centre yields were stable in Q2, retail parks softened by 50 bps to c.6.00%.

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



Source: LSH Research, Experian

REGIONAL FOCUS

PORTFOLIOS PLUNGE

While the Brexit impasse was clearly reflected across all corners of the UK, a sharp drop-off in portfolio deals was a key factor behind Q2's subdued volume overall.

LONDON SLUMPS TO EIGHT-YEAR LOW

Despite Citigroup's £1.1bn purchase of 25 Canada Square, Greater London volume of £4.0bn was the lowest since Q4 2011 and 37% below average. Also, in sharp contrast with Q1, offices dominated volume in the capital once again, with another six deals in excess of £100m in Central London, the largest being Brockton Everlast's £221m purchase of 35 North Wharf Road, W2.

Activity across the Living sectors in the capital was muted, down 70% from Q1's high of £1.6bn to £489m. The only deal over £100m in the Living arena was Henderson Park and Greystar's £101m forward funding of an 894-unit scheme at Nine Elms, Battersea. London's headline retail deal was a Hong Kong investor's £74m (1.58% NIY) purchase of 172 New Bond Street.

EAST MIDLANDS BUCKS THE TREND

Against trend, total volume in the UK regions fared slightly better than London in Q2. At £3.7bn, volume for single-assets across the UK regions combined was 25% below the five-year quarterly average, albeit there were significant contrasts between them.

Scotland and the East Midlands were the only parts of the UK to buck the trend, with Q2 volume 26% and 40% above their respective quarterly averages. At £496m, volume in the East Midlands was boosted by the UK's only large shopping centre deal in Q2, namely Cale Street Partners' £186m (6.60% NIY) purchase of Intu Derby.

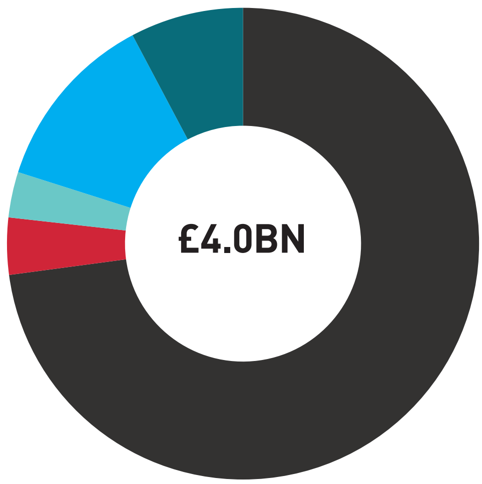
PORTFOLIO VOLUME PLUNGES

Portfolio volume amounted to only £1.1bn and comprised only 17 deals in Q2, the lowest since Q4 2012 and 68% below the five-year quarterly average. Across all sectors, a lack of portfolio stock coming into the market over 2019 largely explained the marked drop-off in activity.

While portfolio activity in the Living sectors and industrial was down significantly on recent trends, retail portfolio volume improved in Q2, albeit from a low base. In addition to the Sainsbury's superstore deal, others included NewRiver REIT's £61m (9.75% NIY) purchase of four retail parks and Palmer Capital Partners' £53m (6.60% NIY) purchase of a B&Q store portfolio.

Q2 2019 LONDON AND REGIONAL BREAKDOWN (£BN)

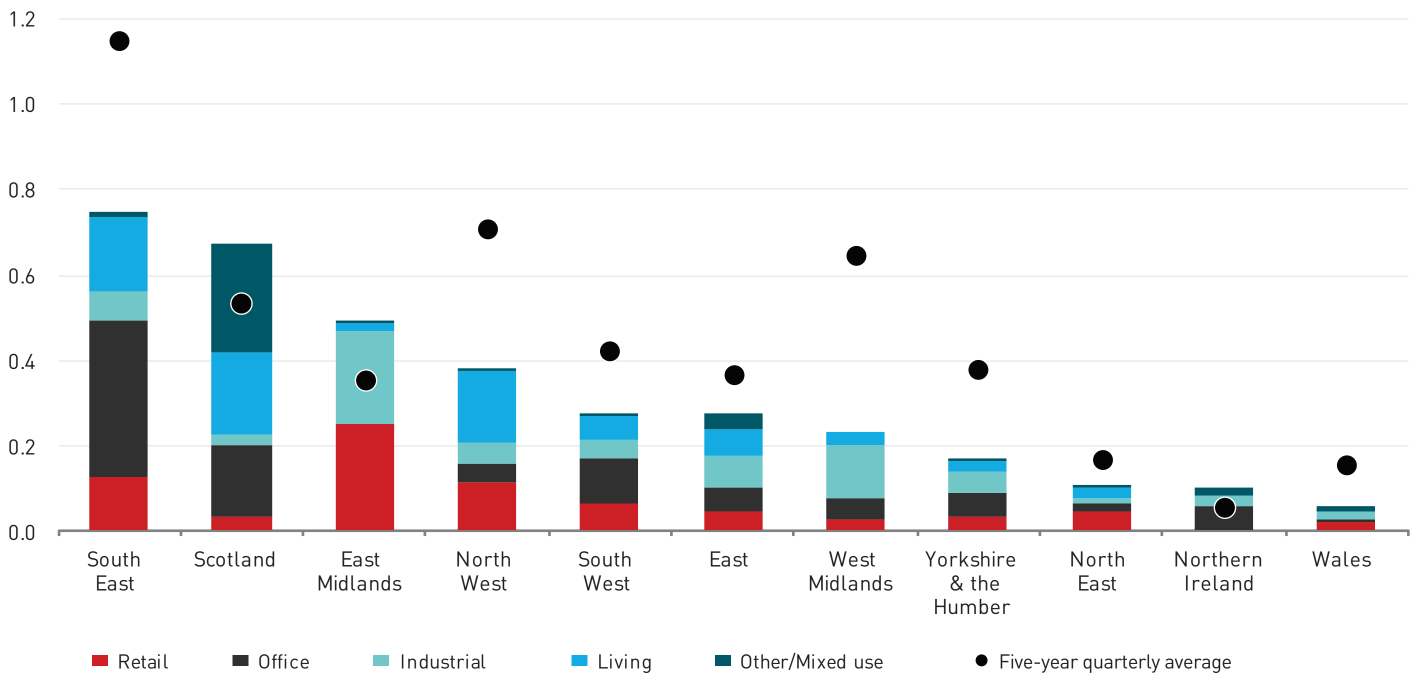
- Office
- Retail
- Industrial
- Living
- Other/Mixed use



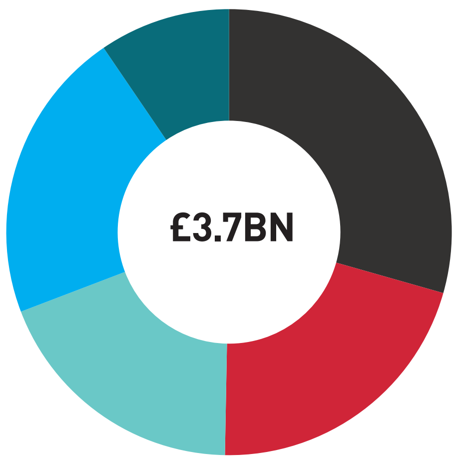
GREATER LONDON

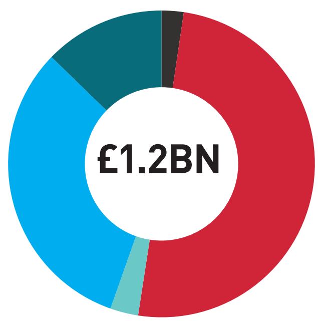
	GREATER LONDON
VS Q1 2019	-9%
VS Q2 2018	-42%
VS FIVE-YEAR QUARTERLY AVERAGE	-35%

Q2 REGIONAL INVESTMENT VOLUME (£BN)



Source: LSH Research, Property Data, PMA





UK REGIONS	PORTFOLIOS
-7%	-61%
-18%	-59%
-25%	-68%

Source: LSH Research, Property Data, PMA

BUYERS & SELLERS

SELLING OUT

The impasse was also evident across each of the main investor types in Q2, while overseas buyers were the only net purchasers of UK commercial property during the quarter.

OVERSEAS DOMINATE REGIONAL OFFICES

Investment from overseas buyers slipped to a six-year low of £4.7bn in Q2. However, in typical fashion, overseas investors were nonetheless net buyers of UK property, to the tune of £2.2bn.

While overseas investment was below par in the majority of sectors, regional offices were a notable exception. Overseas buyers accounted for eight of the ten largest regional office deals in Q2, with total volume of £460m being the highest in three years.

FAR EASTERN INVESTORS HOLD OFF

Having been a key source of capital inflows over recent years, at £854m, investment from the Far East was the lowest since Q1 2014 and 60% below average. However, they remained net buyers, at £306m in Q2, with the largest deal comprising Cindat Capital Management's £135m purchase of 30 South Colonnade in London's Docklands.

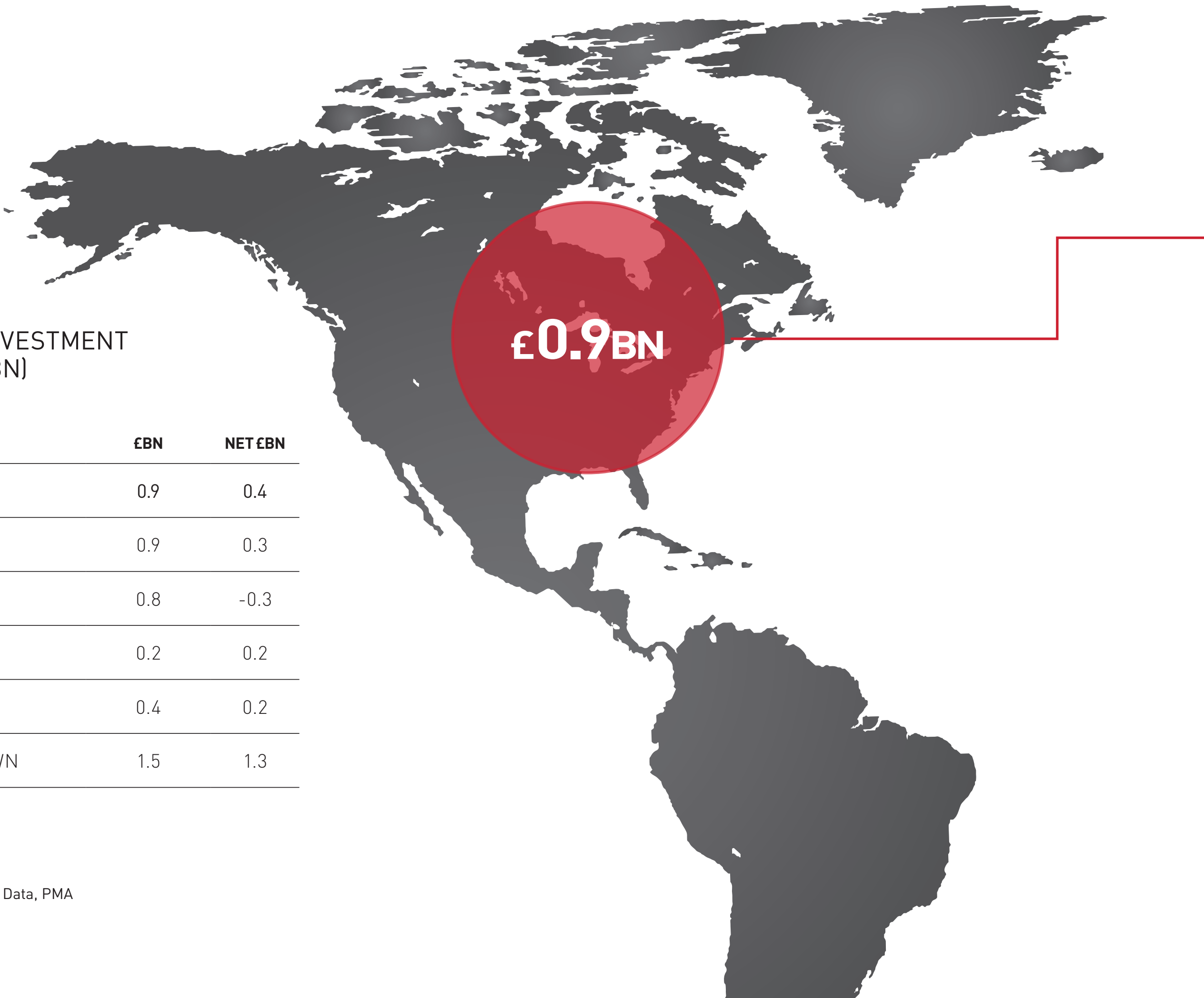
INSTITUTIONS FOCUS ON LIVING

Investment from institutions fell to £1.3bn in Q2, a substantial 40% decrease on the previous quarter and the lowest volume since Q3 2016, which followed the Brexit Referendum. They were also net sellers to the tune of £831m in the quarter, partly reflecting their requirement to maintain cash reserves to guard against redemptions from their property funds.

Institutions were quiet across all sectors except for Student, Healthcare and PRS, where aggregated volume of £396m was 41% above average. Q2's largest institutional deal was M&G's £115m forward fund of a PRS scheme at Arborfield Green Village, Wokingham.

DOMESTIC BUYERS GO QUIET

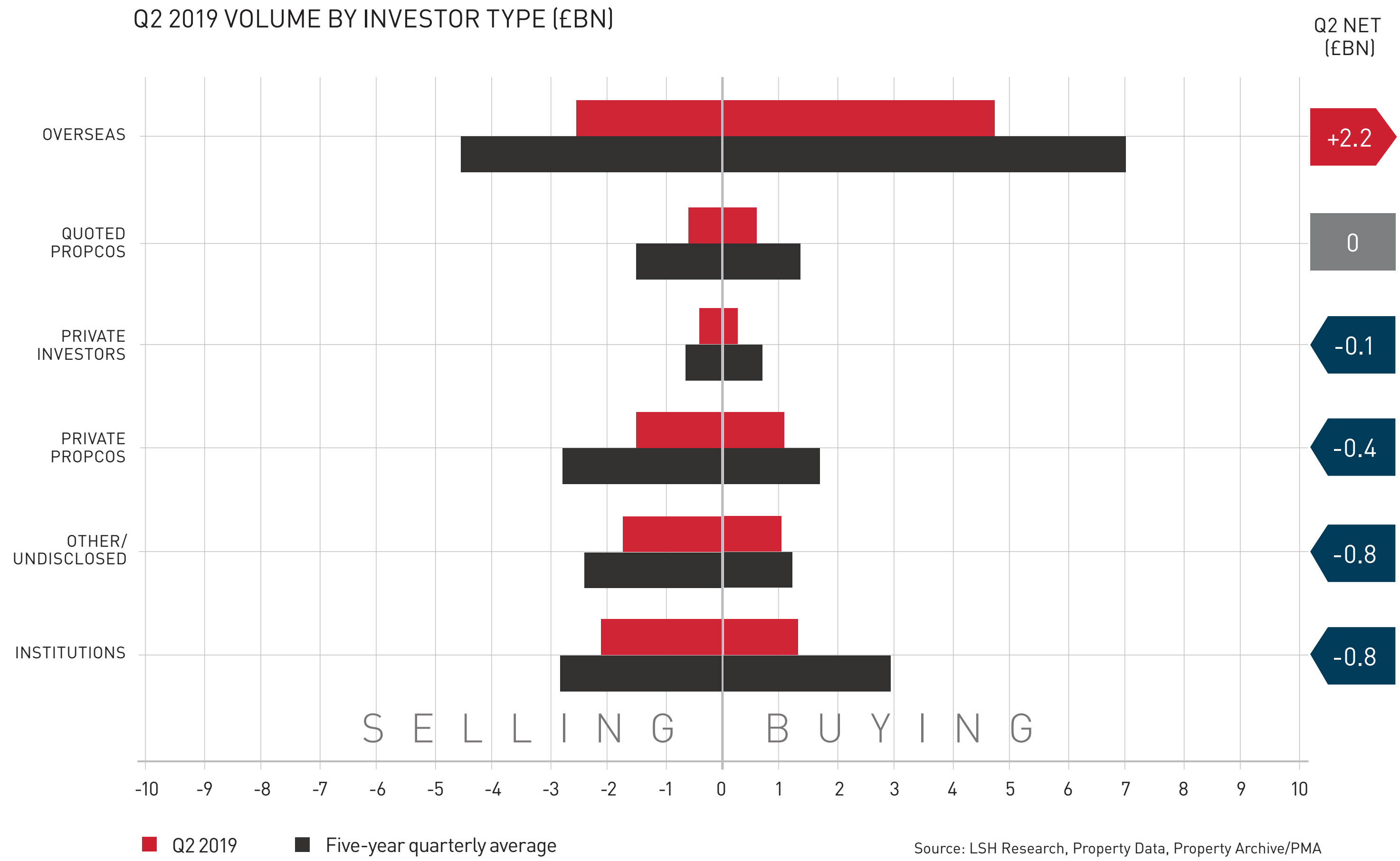
Investment activity was weaker still among other domestic buyer types. Private investors were extremely quiet, with volume of £244m in Q2 the lowest since Q4 2000. Meanwhile, quoted property company investment of £552m was at its lowest level since Q1 2012, albeit they were only marginal net sellers in the quarter.



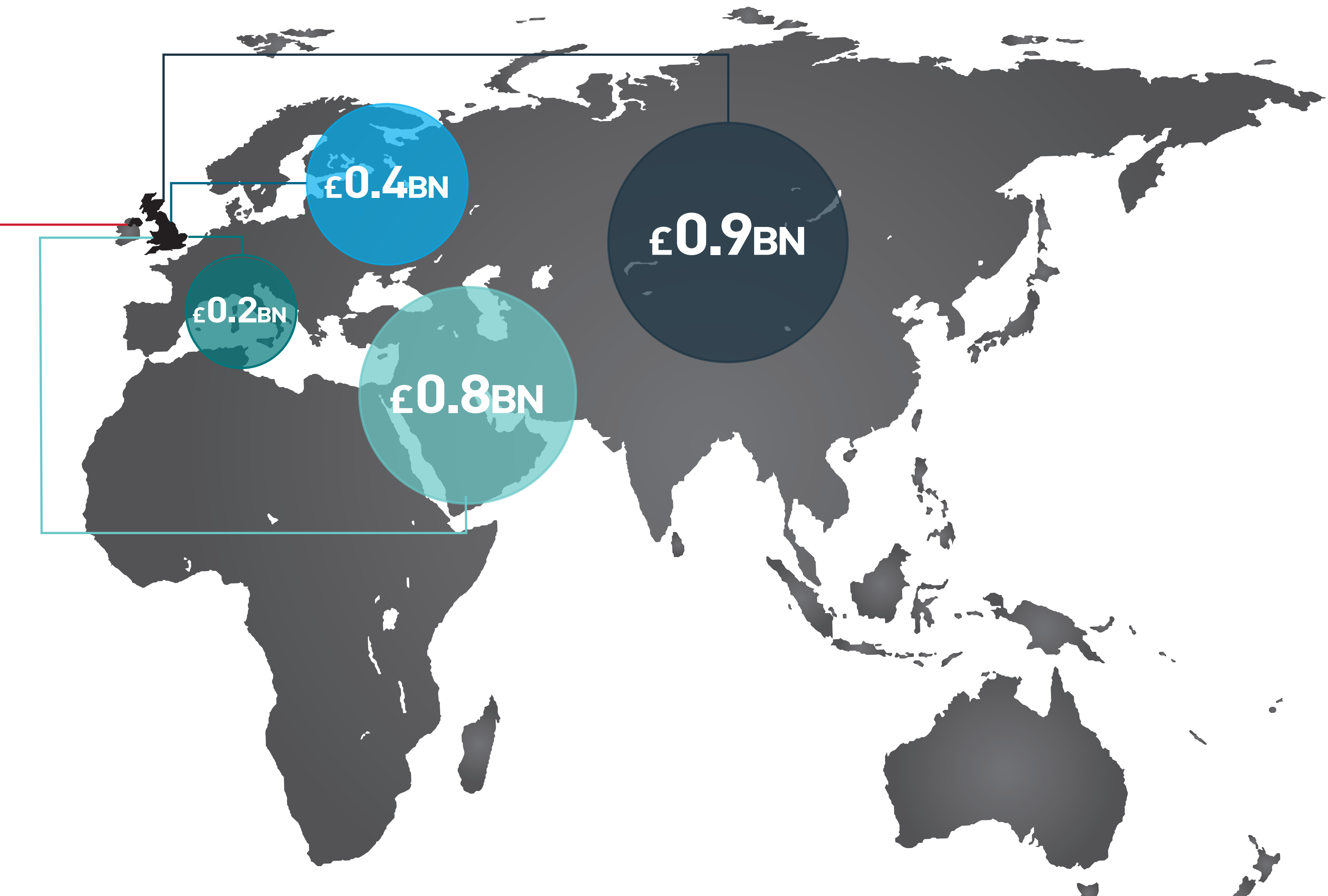
Q2 2019: GLOBAL INVESTMENT FLOWS INTO UK (£BN)

ORIGIN	£BN	NET £BN
NORTH AMERICA	0.9	0.4
FAR EAST	0.9	0.3
MIDDLE EAST	0.8	-0.3
GERMANY	0.2	0.2
EUROPE	0.4	0.2
OTHER/UNKNOWN	1.5	1.3

Source: LSH Research, Property Data, PMA



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



OUTLOOK

BORIS BOUNCE?

As expected, the extension of the Brexit deadline has prolonged the uncertainty, impacting on the economy and delaying investment decisions. We can only hope the new prime minister will make a better fist of it.

NEW RHETORIC, SAME CHALLENGES

New Prime Minister Boris Johnson talked tough on Brexit in his bid to succeed in the leadership contest. As the chosen successor, he will seek to renegotiate the terms of the UK's existing exit deal with the EU, reinstating the prospect of a 'no-deal' as a means to increase his bargaining power.

But can the new prime minister succeed where those before him have failed? In a pre-emptive strike against a possible no-deal, the commons have already voted by a clear margin to block any attempt to prorogue parliament, while the EU has taken a resolute stance against a renegotiation of the existing deal.

Even if renegotiation is possible, time is not on the new PM's side. Standing at circa 73%, latest odds among bookmakers indicate that the UK is widely expected to remain part of the EU beyond the October deadline. The avoidance of a disorderly Brexit will be reassuring for many, but further postponement only prolongs the uncertainty.

NO DEAL RECESSION WARNING

The UK economy appears to have slowed in Q2, amid prolonged uncertainty and an unwinding of the substantial stockpiling that occurred during Q1 in advance of the UK's original EU departure date. Purchasing Managers' Index (PMI) data for the past few months point to a quarterly GDP contraction of approximately 0.1%, which could be the first fall in output in six years.

A recent report by the Office of Budget Responsibility has also laid bare the expected economic impact of a disorderly Brexit. The assessment argues such a scenario will leave a £30bn black hole in public finances, while a combination of higher trade barriers with the EU and a fall in the value of the pound would push the UK into recession in 2020, before recovering in 2021.

MONEY TO PLAY WITH

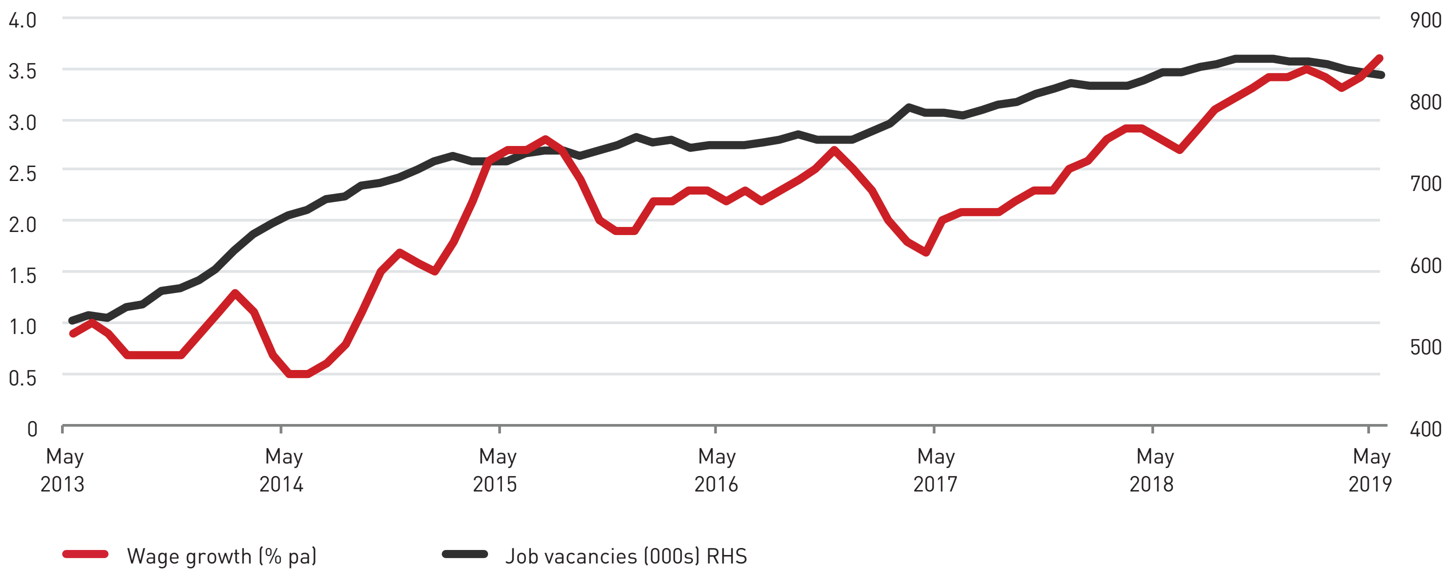
While Brexit may be affecting investment decisions, the UK labour market remains a real bright spot in the UK economy. Unemployment remains rooted at a 44-year low, the employment rate is close to an all-time high, while there are an estimated 830,000 unfilled job vacancies across the UK.

Tightness in the labour market is also feeding through to rising wages. Over the 12 months to June, wage growth increased to 3.6%, its strongest rate in 11 years. In turn, retail sales volumes remain on an upward trajectory, rising by 3.8% over the 12 months to June, with department stores being the only sector to see falling sales, reflecting increased competition from online only retailers.

INCREASINGLY DOVISH

Normally, accelerating pay growth triggers consideration towards a tightening of monetary policy. But these are strange times. The market has interpreted recent comments by Bank of England Governor Mark Carney as an indication that a rate cut is becoming more likely. As a result, 10-year gilt yields moved down sharply in early July, to below 0.7%. The mood is also changing elsewhere, however, with Europe and the US expected to embark on a more dovish approach to monetary policy to maintain growth.

UK WAGE GROWTH AND JOB VACANCIES



Source: ONS

SOUND FUNDAMENTALS

In one sense, the downward movement in gilt yields makes the case for investment in property as compelling as ever. The current spread between 10-year gilts and the All Property average transaction yield stands at a near record high of 480bps. The flipside is that prime yields, which in most sectors bar retail stand at or near record lows, depend heavily on this status quo being sustained.

At this stage in the cycle, with the period of yield compression largely exhausted, strategies around income generation will be key to maximising returns. Consequently, regardless of the Brexit outcome, a strong weight of domestic and overseas capital will continue to seek out secure long-income product, helping to support pricing.

VALUES UNDER PRESSURE

Despite limited distress in the market and the risk premium associated with UK property, All Property values have fallen slightly throughout 2019. According to MSCI, All Property capital values have fallen in each of the past seven months, albeit this remains driven by ongoing value falls in the retail sectors and a growing aversion to secondary assets more generally in the market.

As a result, LSH's All Property total return forecast has been clipped again for 2019, down to 2.1% and reflecting a 2.3% fall in values. Assuming the avoidance of a disorderly exit from the EU, returns are forecast to pick up from 2020, however, averaging circa 6.0% for the five-year period running 2019 to 2023. A no-deal exit would substantially alter the shape of the forecast, although a steeper fall in values and a fall in the pound would present opportunistic investors with a major buying opportunity.

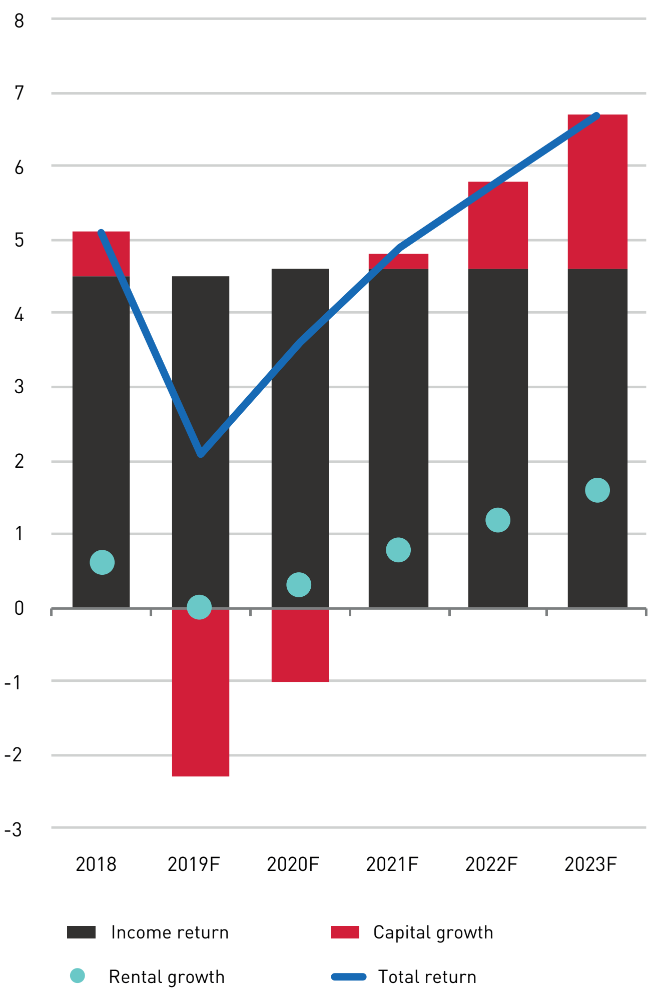
HUNTING OUT GROWTH

Notwithstanding current uncertainty, pockets of tight supply continue to support rental growth prospects in the business space markets. While industrial remains the lead performing sector in our forecast, value-add strategies in the UK's regional office markets in our view offer the best prospects for outperformance. As ever, a deep understanding of the micro location will be key, while confidence to invest in this sphere will rely on greater certainty being restored.

SITTING ON HANDS

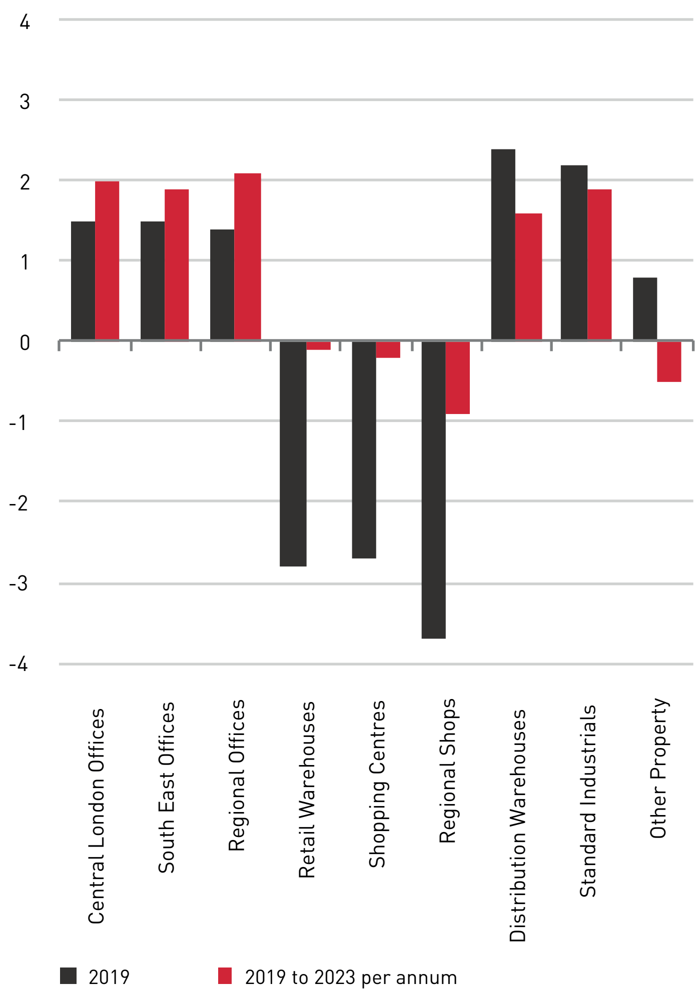
Uncertainty over the Brexit outcome will continue to weigh on buyer appetite. Meanwhile, with limited distress in the current market, vendors are under little pressure to sell below valuations. Thus, despite an otherwise strong weight of money in the market, the subdued volume of Q2 is set to be repeated in Q3 and to continue throughout the year if Brexit is unresolved in October. If a Brexit deal can be achieved, we can expect a substantial release of pent up demand to drive strong volumes in Q4 and Q1 2020.

ALL PROPERTY PERFORMANCE FORECAST (%)



Source: MSCI, RealFOR, LSH Research

RENTAL GROWTH FORECAST (%)



Source: RealFor, LSH Research

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