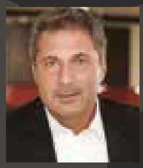
UKIT

UK INVESTMENT TRANSACTIONS BULLETIN

Q3 2016

BREXIT: HARD OR SOFT?



Ezra Nahome
CEO

At our recent UKIT event, a unanimous show of hands confirmed that, four months on from the Referendum result, the UK economy and property markets have been far more resilient than initially expected. Although increasing talk of a 'hard Brexit' suggests greater challenges lie ahead, uncertainty over its impact is sure to create both risk and opportunity.

While Q3 volume slipped to its lowest level in three years, the Referendum result arguably attracted overseas investment rather than deterred it, helped by the weaker pound and a sell-off of quality assets from the retail funds. The continued inflow of overseas capital also underlines that the investment fundamentals in UK property remain on a sound footing.

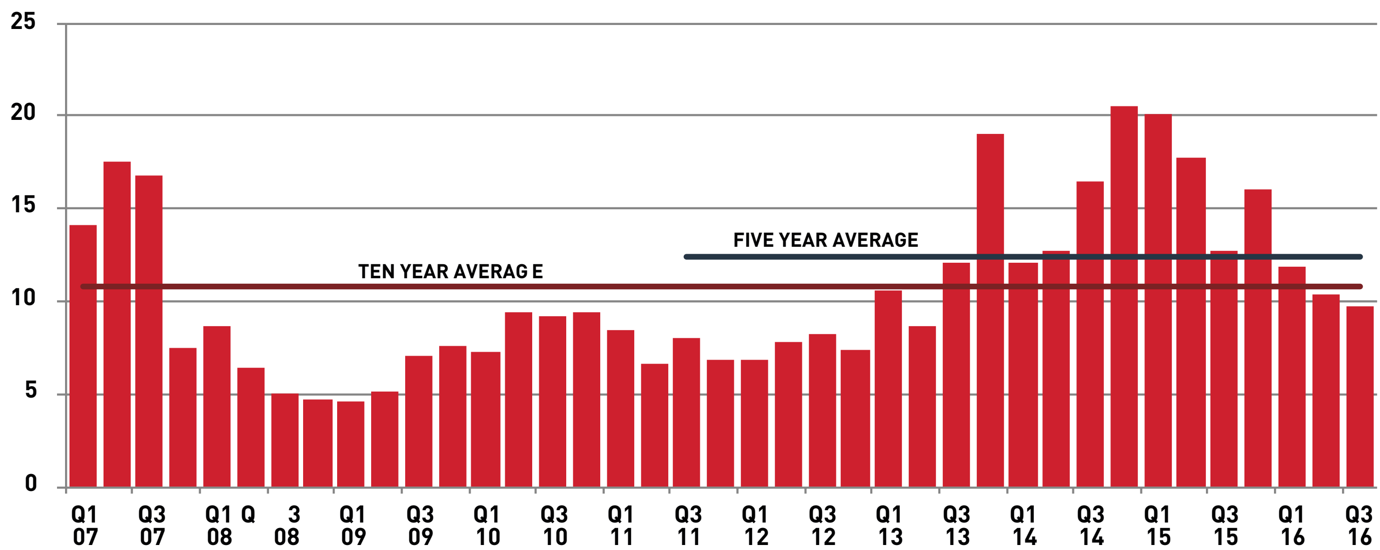
Even if growth prospects have dampened post-Referendum, property continues to look relatively attractive against alternative assets such as bonds, and there is little to suggest the position will materially change in the foreseeable future.

Increased uncertainty in the outlook will inevitably focus investment demand on secure income, meaning prime and long-leased investments are likely to be protected from pricing pressures. Correspondingly, the heightened perception of risk will put more pressure on pricing for secondary or non-core assets.

However, if the markets price in too much risk around the feared consequences of a 'hard Brexit', some of the most exposed-looking sectors may be the source of greatest opportunity.

Q3 also saw the emphatic arrival of local authorities to the market. With their budgets facing growing pressure and interest rates at an all time low, a number of forward-thinking councils have started to make their balance sheet work harder by acquiring commercial property, and we expect this trend to continue over the coming quarters.

UK INVESTMENT VOLUME (£BN)



Source: LSH Research, Property Data, Property Archive

Q3 ACTIVITY

Sector focus

Q3 volume of £9.7bn was its lowest since Q2 2013 and 22% below the five-year quarterly average. The majority of sectors recorded below average volume, with shops and specialist the only exceptions.

September rally rescues quiet quarter

Q3's subdued volume largely reflected an extremely quiet summer period, as the market came to terms with the shock of the Referendum result. However, activity recovered significantly in the latter part of Q3, with September's volume of £5.2bn the third highest on record for that month.

Offices take the biggest hit

Total office volume slipped to a five-year low of £3.0bn in Q3 and, at 44% below the five-year quarterly average, was the weakest performer of the core sectors in relative terms. While all the sub-sectors saw below average volume, Central London fared worst, with volume 53% below trend.

At only 4% below average, office parks had the strongest relative performance with Q3 volume of £460m. However, this was predominantly made up of Spelthorne Borough Council's £360m (NIY 4.5%) acquisition of The BP International Centre, in Sunbury-on-Thames.

Industrial activity holds up

At £1.0bn, Q3 industrial volume was relatively resilient, down 17% on the five-year quarterly average. This included one of the largest ever industrial deals on record, Legal & General's £150m (NIY 5.25%) forward-funding of Amazon's distribution centre at London Distribution Park, Tilbury

South East industrial saw the healthiest volume relative to trend, down only 4% on the five-year average. Q3's £180m volume was boosted by Capital Industrial's £79.5m (NIY 5.10%) acquisition of Heston & Airlinks Industrial Estate, Heathrow from SEGRO.

Major high street deals drive retail volume

At £2.8bn, retail was the only core sector where Q3 volume was ahead of average. With subdued activity for retail warehouses and especially shopping centres, this was due to an outstanding quarter for shops, with volume of £1.9bn the third strongest quarter on record.

Shop volume was dominated by several major deals, including Fortress Investment Group's £450m (NIY 6.60%) acquisition of Topland's M&S portfolio of 76 stores; and Ramsbury Estates' £400m (NIY 2.60%) purchase of the Debenhams flagship store at 334-338 Oxford Street from British Land.

Alternatives volume picks up

Following a quiet Q2, volume in the alternative sectors rebounded to £2.3bn in Q3, 10% above the five-year average. This included Q3's largest deal, Davidson Kempner Capital's £500m acquisition of the NCP Portfolio of 88 car parks from Blackstone; and GSA's £430m purchase of the Threesixty student accommodation portfolio from Oaktree Capital.

Q3 INVESTMENT VOLUME (£BN)

SECTOR	Q3 2016	VS Q2 2016	VS Q3 2015	VS 5-YEAR AVG
Shops	£1.90	98%	144%	81%
Shopping Centres	£0.30	-62%	-71%	-68%
Retail Warehouse	£0.55	-9%	-55%	-10%
ALL RETAIL	£2.75	17%	-9%	6%
Central London Offices	£1.72	-44%	-53%	-53%
Rest of South East Offices	£0.34	-13%	-52%	-43%
Rest of UK Offices	£0.49	4%	-48%	-23%
Office Parks	£0.46	-49%	-4%	-4%
ALL OFFICE	£3.01	-38%	-48%	-44%
South East Industrial	£0.18	50%	115%	-4%
Rest of UK Industrial	£0.28	-25%	6%	-21%
Distribution Warehouse	£0.52	-17%	-44%	-18%
ALL INDUSTRIAL	£0.98	-13%	-23%	-17%
Hotels & Leisure	£0.67	-35%	-51%	-38%
Specialist	£1.67	106%	273%	57%
Mixed-use (single assets & portfolios)	£0.62	203%	-26%	-43%
ALL PROPERTY	£9.69	-6%	-24%	-22%

Source: LSH Research, Property Data, Property Archive

Transaction yield sees modest rise

Set against slowing volume, the average All Property transaction yield has been relatively steady post-Referendum. The average All Property transaction yield moved up for a second consecutive quarter in Q3, albeit by only 6pbs, to stand at 5.70%.

Q3's yield movement infers that average prices softened by 1.0%, although this also reflects increased investor activity in lower yielding and / or more liquid assets. By way of comparison, IPD's valuation-based benchmark reveals that All Property capital values fell by 3.7% during the period.

The Referendum's impact on pricing focused on larger lot-sizes, as institutional investors sold at a discount to pre-Referendum values. Indeed, while the average transaction yield for sub-£20m lot-sizes moved in by 15bps in Q3, it moved out by 25bps for £20m plus lot-sizes.

Pricing softens for Central London offices

Despite stability at the All property level, there was notable variation in transaction yield movements between sectors. The Central London office yield moved out by 37bps in Q3 to stand at 4.44%, its highest level since Q1 2015, while the other office sub-sectors moved in during the quarter.

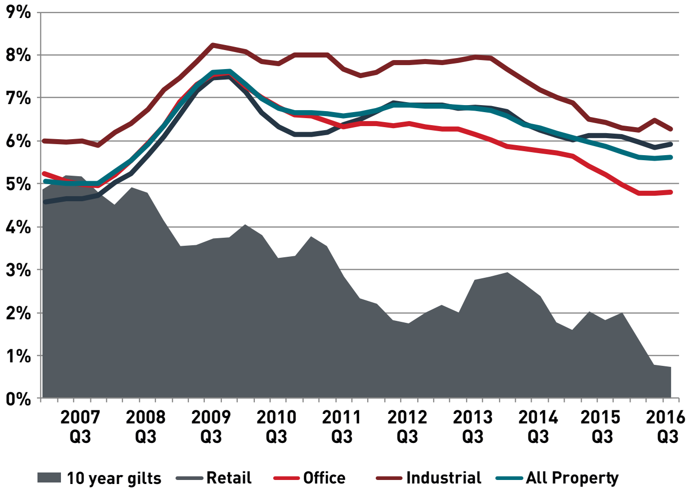
Sentiment also indicates that, since Q2, prime office yields have also softened by circa 25bps in the City and West End. This reflects both a more bearish stance over the medium term prospects for the occupier markets and a willingness to sell at a discount to pre-Referendum levels.

Industrial yield hits record low

Industrial was the only core sector to see yields harden in Q3, moving down to a record low of 5.54%. This reflects the high level of demand relative to stock, with the growth of e-commerce and the sector's income qualities placing it in a favourable light.

Investment demand for industrial has arguably recovered to its pre-Referendum level, with multiple bids seen in the market and record high pricing being achieved. In Q3 alone, prime yields for South East multi-let estates moved in by 50bps to stand at 4.75%.

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



Source: LSH Research, FT.com

Q3 2016 YIELDS

SECTOR	Transaction yields: Q3 2016	Transaction yields: 3 MONTH MOVEMENT (BPS)	Transaction yields: 12 MONTH MOVEMENT (BPS)	Prime yields: Q3 2016	Prime yields: 3 MONTH MOVEMENT (BPS)	Prime yields: 12 MONTH MOVEMENT (BPS)	YIELD SENTIMENT
Shops	4.45%	-8	-37	4.00%			
Shopping Centres	6.60%	9	25	5.50%*		25	
Retail Warehouse	6.43%	78	-10	4.50%		25	
ALL RETAIL	6.00%	34	-2	-	-	-	-
Central London Offices	4.44%	37	69	3.50%	25	25	
Rest of South East Offices	5.97%	-21	-93	5.00%			
Rest of UK Offices	6.05%	-5	-66	5.00%		25	
Office Parks	5.03%	-198	-192	6.00%		25	
ALL OFFICE	4.91%	4	7	-	-	-	-
South East Industrial	5.36%	-205	-61	4.75%	-50	-25	
Rest of UK Industrial	6.05%	-153	-141	6.00%	-25		
Distribution Warehouse	5.42%	-16	-68	4.25%			
ALL INDUSTRIAL	5.54%	-152	-82	-	-	-	-
Hotels & Leisure	5.94%	33	-64	4.75%			
Specialist	5.80%	17	44	4.75% **		-25	
Mixed-use (single assets & portfolios)	7.77%	192	318	-	-	-	-
ALL PROPERTY	5.70%	6	5	-	-	-	-

Source: LSH Research, Property Data, Property Archive

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

Regional focus

A number of major portfolio sales to overseas buyers was key to overall volume in Q3, with volume for single assets down markedly, both in London and across the UK regions as a whole.

Major portfolios sales boost volume

£2.8bn worth of portfolios changed hands in Q3, up 70% from Q2's subdued level and 3% above the quarterly average. Portfolio volume was a key feature of Q3, accounting for 29% share of total volume, its second highest share on record.

That said, the number of portfolio deals was actually its lowest in over two years, with activity driven by several major transactions. The three largest were the £500m NCP portfolio deal; the £450m M&S portfolio and the £430m Threesixty student accommodation portfolio.

London volume sinks to five-year low

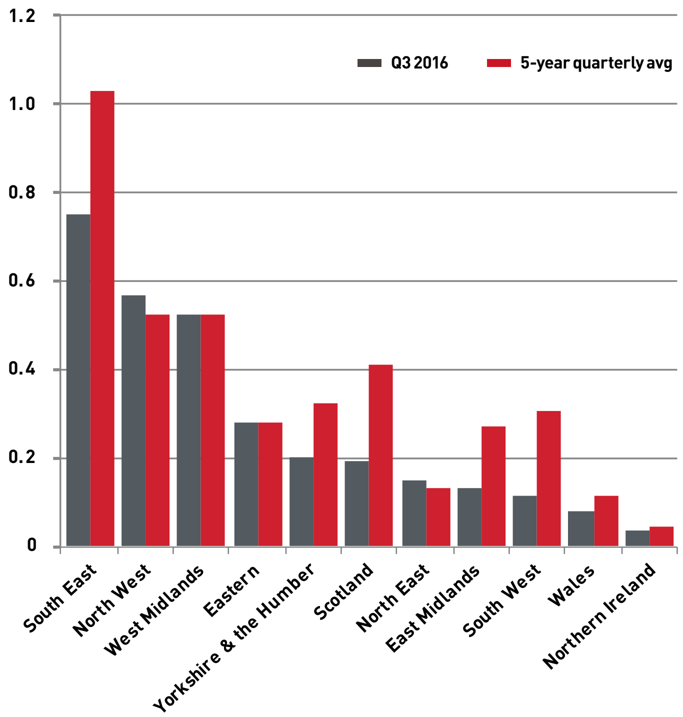
At £3.8bn, Greater London volume in Q3 was its lowest in five years and 33% below its five-year quarterly average. This stemmed from a very quiet quarter for Central London offices, which was partly offset by £1.0bn of retail volume, 43% above the five-year quarterly average.

Retail volume in the capital included two major deals, the aforementioned Debenhams store on Oxford Street; and Richemont's £198m (NIY c.2.75%) purchase of Mulberry's flagship store on Bond Street from Aberdeen Asset Management.

The Northern powerhouse steams ahead

Single asset investment outside London totalled £2.9bn in Q3, 28% below the five-year quarterly average and the lowest since Q1 2013. All regions were down on the same period last year and seven of the 11 regions were below their five-year quarterly averages.

REGIONAL INVESTMENT VOLUME (£BN)

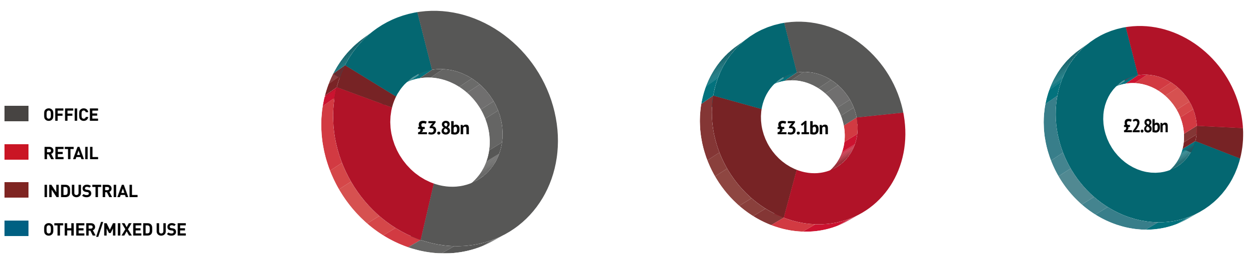


Source: LSH Research, Property Data, Property Archive

The North East and North West saw the greatest volume of activity against trend, 12% and 7% above the five-year quarterly average respectively. Manchester was home to the largest single asset deal outside London, namely DEKA Immobilien's £164m (NIY 5.25%) purchase of 1 St Peters Square from Argent Developments.

LONDON AND REGIONAL BREAKDOWN (£BN)

	GREATER LONDON	UK REGIONS	PORTFOLIOS



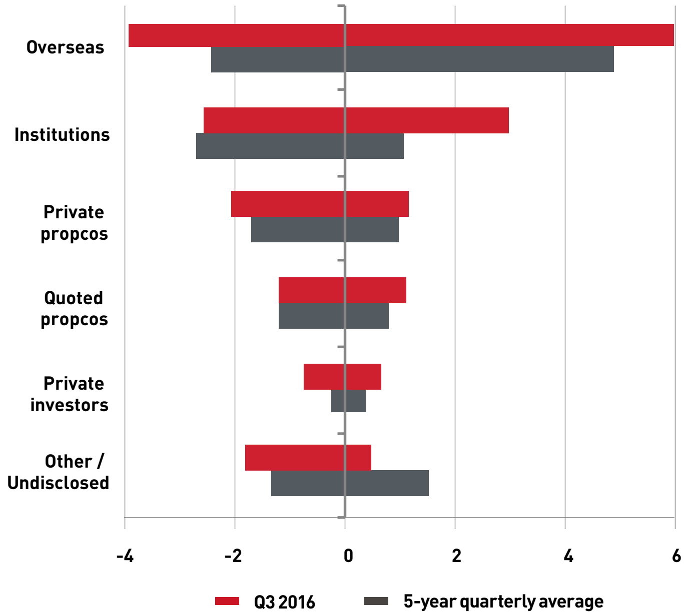
	GREATER LONDON	UK REGIONS	PORTFOLIOS
VS Q2 2016	-12%	-30%	72%
VS Q3 2015	-29%	-45%	56%
VS 5-YEAR QTY AVG	-33%	-23%	3%

Source: LSH Research, Property Data, Property Archive

Buyers and sellers

The course of 2016 has brought a clear switch in behaviour among institutional investors, while the emphatic emergence of local authority investment was a notable feature of Q3 activity.

VOLUME BY INVESTOR TYPE (£BN)



Source: LSH Research, Property Data, Property Archive

Spike in redemptions accelerates institutional sell-off

Net-selling among UK institutions accelerated in Q3, amounting to £1.7bn, its highest level since Q2 2008. While the sell-off after the 2008 downturn was linked to high levels of distress, the majority of sales over the past six months have crystallised substantial gains.

A spike in redemptions post-Referendum focused the selling among retail funds. Aberdeen Asset Management was the largest net seller in Q3, at £624m, followed by Henderson, at £597m. Meanwhile, institutional purchases comprised only 24 buyers in Q3, down from 40 in Q2.

Quoted companies follow suit

The fall in share prices of quoted property companies in the aftermath of the Referendum has also prompted a switch from net-buying earlier in 2016 to net-selling in Q3. Quoted companies were net-sellers to the tune of £0.4bn, albeit half of this was accounted for by British Land's sale of the Debenhams portfolio.

Overseas investors capitalise on weaker pound

Despite increased risks to the UK's economic growth prospects, overseas investors remain major net buyers of UK property. At £4.9bn, Q3 was the strongest level of overseas investment in 2016 to date, and significantly outweighed disposals, equating to net investment of £2.5bn.

The sharp fall in sterling prompted by the Referendum result undoubtedly attracted opportunistic overseas interest. Overseas buyers provided a key source of demand for institutional sales – by volume, 60% of Q3's institutional sales went to an overseas purchaser.

For the sixth consecutive quarter, Far Eastern investors were the largest net-buyers of UK property, amounting to £1.3bn in Q3.

Public sector emerges as key player

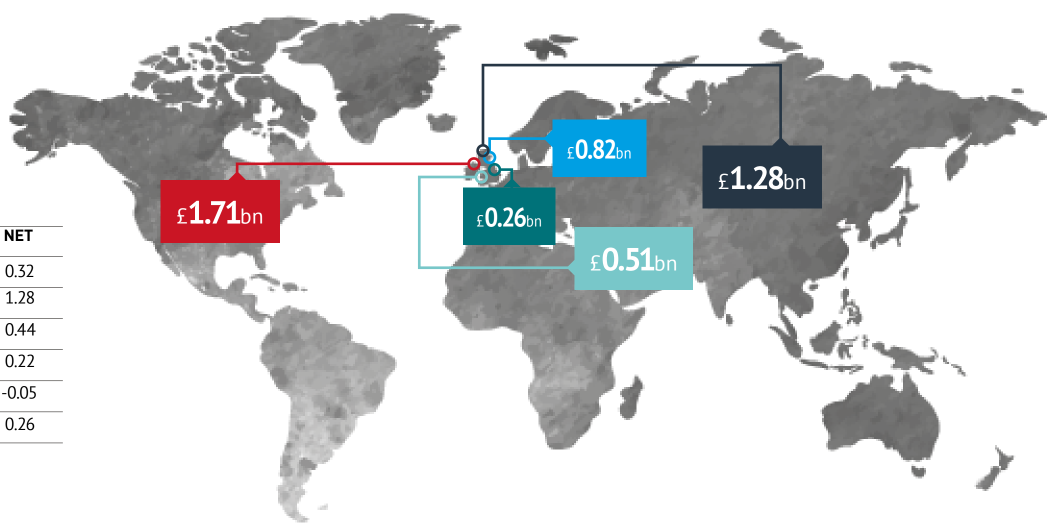
Q3's subdued volume was partly offset by the rapid emergence of local authority buyers to the market. Councils purchased £750m worth of assets in Q3, close to four times the previous record set in Q4 2012.

This included Spelthorne Borough Council's £360m (NIY 4.5%) acquisition of the BP International Centre in Sunbury-on-Thames, the largest ever purchase by a local authority.

Notably, local authority investment in Q3 included several deals that were outside their jurisdictions, thereby ruling out regeneration as the primary rationale for buying. For example, Portsmouth City Council purchased Chrome 102, Minworth, from Rockspring for £12.4m (NIY 5.05%).

Q3 2016: GLOBAL INVESTMENT FLOWS INTO UK (£BN)

ORIGIN	£BN	NET
North America	1.71	0.32
Far East	1.28	1.28
Middle East	0.51	0.44
Germany	0.26	0.22
Europe	0.82	-0.05
Other	0.33	0.26



Source: LSH Research, Property Data, Property Archive

OUTLOOK

Increasing talk of a 'hard Brexit' suggests the journey towards the EU exit door may be bumpier than many had hoped. However, if the wider investment community prices in too much risk over the road ahead, it could be a source of opportunity in the market.

So far, so good in the economy?

A host of indicators reveal that sentiment in the economy has rebounded after the shock of the Referendum result. At 0.5%, the preliminary estimate of Q3 GDP growth confirms that the UK will not only avoid recession as some had feared, but will actually post respectable growth in 2016 as a whole.

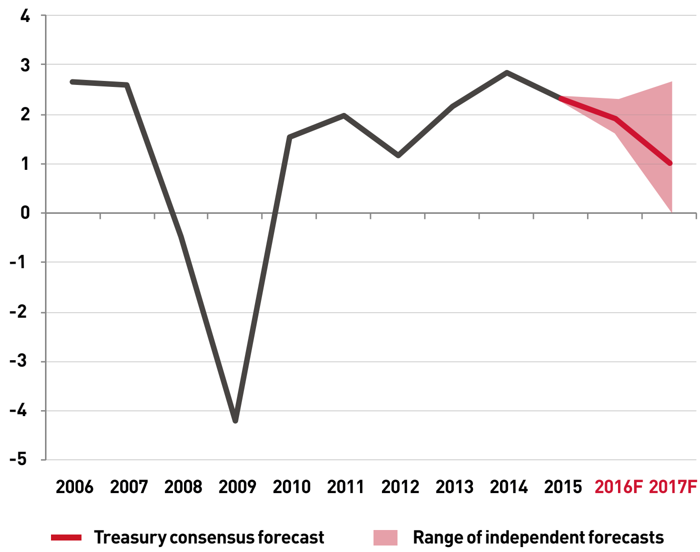
Yet some of the good news is at least partly down to steps taken by the Bank of England, with the interest rate reduced to a paltry 0.25% alongside a fresh round of quantitative easing. Furthermore, sterling's marked depreciation since the Referendum will feed through into rising inflation over the next 12 months, potentially impacting on real wages and consumer spending.

Uncertainty abounds in 2017

Other than Theresa May's pledge to invoke Article 50 by March 2017, the nature of the UK's exit from the EU remains highly uncertain. Recent noises, both domestically and in Europe, suggest the UK is headed for a 'hard Brexit'. While some welcome this, loss of unfettered access to the single market has raised concerns among major UK exporters and the financial services industry.

For better or worse, the route to Brexit may also be influenced by economic and political developments in the wider world. For example, the result of November's US election may 'trump' any global concerns over Brexit, while a string of key elections in Europe may also complicate negotiations.

UK GDP GROWTH (% P.A.)



Source: Treasury consensus forecast, ONS

With so much uncertainty it is little wonder that economists have wide-ranging views in their forecasts after 2016. The Treasury's October consensus report reveals expectations for UK GDP growth in 2017 ranging from zero up to 2.6%. Inevitably, uncertainty in the growth outlook translates into the property market.

Supportive fundamentals

There are two key underlying factors which should mitigate a severe adverse reaction in the market. First, UK property remains relatively attractive as an asset class. While UK gilt yields have edged up in early Q4, the gap between 10-year gilts and All Property yields remains substantial. Bond rates would need to rise sharply and significantly to materially impact on pricing, a scenario which seems unlikely in the current environment.

Second, even if increased business uncertainty does weigh on occupier demand, supply is broadly in check, mitigating sharp falls in rental levels. In the past, economic downturns have coincided with high levels of supply, exacerbating the impact on rental levels.

Consequences of uncertainty

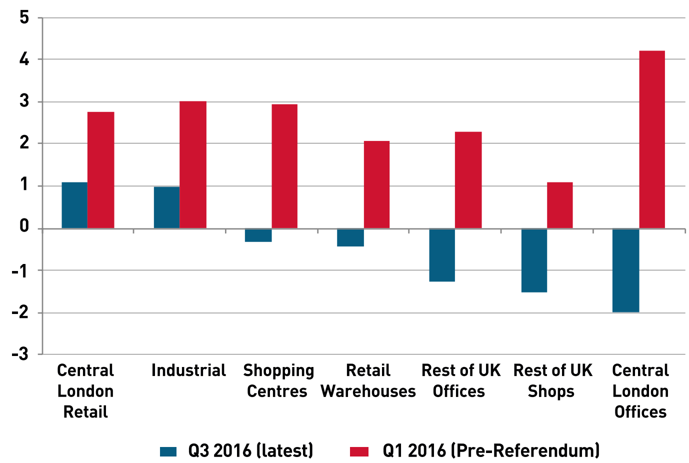
One clear consequence of uncertainty is a flight to quality. Risk averse investors will sharpen their focus on secure income, including long-leased assets to strong covenants. With quality stock in short supply, this should support prices at the prime end of the market.

Conversely, increased risk over the outlook for the economy will focus price correction on lower quality stock and, crucially, those sectors that are perceived as relatively exposed to what could be a 'hard Brexit'.

While our rental growth forecasts for 2017 have been pared back across the board, there is wide variation between sectors. For example, in Industrial, the favourable supply-demand dynamic translates into a continuation of rental growth.

In contrast, rental growth expectations in Central London offices have been sharply downgraded for 2017. This reflects the capital's exposure to financial services, the impact of the rating revaluation on occupier costs and concerns regarding possible oversupply.

2017 RENTAL GROWTH FORECAST: PRE VS POST-REFERENDUM (%)



Source: RealFOR

Ezra Nahome
CEO
+44 (0)20 7198 2222
enahome@lsh.co.uk

Nick Lloyd
Head of Capital Markets
+44 (0)20 7198 2221
nlloyd@lsh.co.uk

Oliver du Sautoy
Head of Research
+44 (0)20 7198 2193
odusautoy@lsh.co.uk

Isabel Watterson
Research
+44 (0)20 7198 2258
iwatterson@lsh.co.uk

Darren Sheward
Director – Bristol
+44 (0)117 914 2041
dsheward@lsh.co.uk

Adam Ramshaw
Director – Birmingham
+44 (0)121 237 2395
aramshaw@lsh.co.uk

Bill Lynn
Director – Newcastle
+44 (0)191 338 8294
blynn@lsh.co.uk

Paddy Brennan
Director – Belfast
+44 (0)28 9026 9206
pbrennan@lsh.co.uk

Abid Jaffry
Director – Manchester
+44 (0)161 242 7099
ajaffry@lsh.co.uk

Ewen White
Director – Glasgow
+44 (0)141 266 6777
ewhite@lsh.co.uk

Andrew Shiells
Director – Edinburgh
+44 (0)131 226 0333
ashiells@lsh.co.uk

lsh.co.uk
lshinvestmentsales.co.uk

Lambert Smith Hampton