UKIT

UK INVESTMENT TRANSACTIONS BULLETIN

Q2 2016

Lambert Smith Hampton

UNCHARTED WATERS AHEAD

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It seems hard to believe over a month has passed since the UK electorate voted to leave the European Union, a result which confounded expectations. It's been a tumultuous period, both in the markets and politically, but I believe we're getting greater clarity about the outlook for UK commercial property with every passing week.

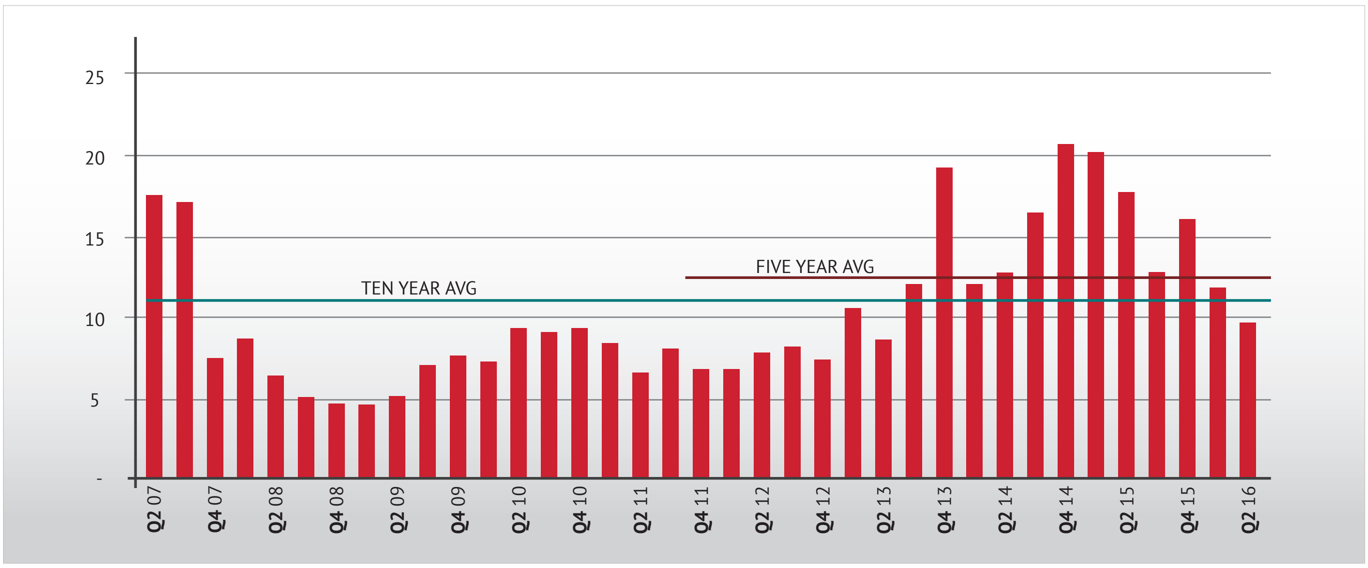
While the result has sent us into uncharted waters, it is reassuring to see cooler heads already returning to the market. The share prices of many of the UK's REITS have recovered lost ground following dramatic falls, while some of the major retail funds are having notable sales successes to meet the spike in redemptions.

Nonetheless, at the all property level, we now expect values will fall by over ten per cent in 2016. This is magnified by our position late in the cycle - values have been stretched across a number of sectors for a while, especially in Central London, so the Referendum result has arguably triggered the correction that many were anticipating.

Of course, there will be winners and losers from this. Well-located properties with long leases will hold up very well; while secondary assets in the more exposed sectors are likely to endure a sharper price adjustment. The regions may also perform well against London over the short to medium term in terms of both occupancy and investment until we have a better understanding of the capital's future outside of the EU.

Beyond 2016, much depends on what Brexit looks like. While this is highly uncertain at this stage, UK property is in a fundamentally much stronger position than it was in 2008 and there is much to be confident about in the long term. Investors who can look beyond the immediate uncertainty will be well placed to benefit.

UK INVESTMENT VOLUME (£BN)



Source: LSH Research, Property Data, Property Archive

REVIEW OF Q2 ACTIVITY

Sector focus

£9.8bn worth of assets changed hands in Q2, down 18% on Q1 and the lowest since Q2 2013. Yet considering the market uncertainty around June's Referendum, Q2's volume was arguably respectable, standing only 20% below the five-year quarterly average.

SHARP DROP-OFF FOR ALTERNATIVES

Having been pivotal to 2015's record year of volume, investment into alternatives has slowed markedly - Q2's volume of £1.3bn was 74% down on the same period last year. Investment into hotels & leisure was particularly subdued, down almost 60% quarter-on-quarter and on the five-year quarterly average.

REBOUND IN CENTRAL LONDON SUPPORTS OFFICE VOLUME

Office investment totalled £4.9bn in Q2, recovering 7% on Q1 but 10% short of the five-year average. Despite the capital's potential exposure to Brexit, investment in Central London offices rebounded by 38% during Q2 to £3.1bn. That said, Q2 volume followed a very subdued Q1 and was still 17% below average.

The largest office transaction in Q2, and indeed of any sector, was Mapletree's £563m purchase of Green Park, Reading from Oxford Properties. The deal alone accounted for 60% of office park volume, which, at £0.9bn, was the only office sub-sector to see higher volume in Q2 compared with the same period last year.

INDUSTRIAL AND RETAIL ACTIVITY HOLDS UP

At £1.1bn, industrial volume slipped to its lowest level since Q2 2013 but was nonetheless only 4% below the five-year quarterly average. This resilient figure was underpinned by above average volume in the regional multi-let assets, and boosted by Malaysian Employees Provident Fund's £200m acquisition of the Project Phoenix portfolio from IM Properties.

Similarly, Q2 retail volume of £2.4bn was only 8% short of the quarterly average. Of the retail sub-sectors, shopping centres saw the weakest activity against trend, down 16% on both Q1 and the five-year average. This was in spite of Intu's £410m (5.20% NIY) acquisition of a 50% stake in Merry Hill, Dudley from Queensland Investment Corporation, which was the second largest deal of the quarter.

AVERAGE TRANSACTION YIELD HEADS UPWARDS

Alongside decreasing volume, evidence suggests that pricing softened during Q2 following eight successive quarters of downward yield movement. The average All Property transaction yield moved up by 15bps during Q2 to stand at 5.64%, equivalent to a 2.7% fall in values. The average yield increased in each of the core sectors, most notably industrial, which rose by 81bps during the quarter.

The upward movement likely reflects a moderation of price expectations in view of the heightened investor uncertainty, particularly for secondary assets. However, anecdotal market evidence indicates that pricing has been resilient for prime assets, both in the lead up and the immediate aftermath of the Referendum.

Q2 2016 AVERAGE YIELDS AND VOLUME

	Transaction volume £bn			Transaction yields		
Sector	**Q2 2016**	**Vs Q1 2016**	**Vs Q2 2015**	**Q2 2016**	**3 month movement (bps)**	**12 month movement (bps)**
Shops	£0.96	-2%	-25%	4.53%	8	-8
Shopping Centres	£0.79	-16%	-39%	6.50%	50	-108
Retail Warehouse	£0.60	20%	-14%	5.65%	-43	-28
All Retail	**£2.35**	-3%	-28%	5.66%	3	-52
Central London Offices	£3.09	38%	-25%	4.07%	27	-4
Rest of South East Offices	£0.39	-53%	-52%	6.18%	-10	27
Rest of UK Offices	£0.47	-65%	-25%	6.10%	-46	-26
Office Parks	£0.90	751%	40%	7.01%	-31	8
All Office	**£4.85**	7%	-22%	4.87%	8	3
South East Industrial	£0.12	-34%	-42%	7.41%	145	152
Rest of UK Industrial	£0.38	-40%	-27%	7.58%	63	88
Distribution Warehouse	£0.63	4%	-18%	5.58%	-60	-40
All Industral	**£1.12**	-20%	-24%	7.05%	81	95
Hotels & Leisure	£0.45	-58%	-78%	5.61%	25	19
Specialist	£0.81	-31%	-71%	5.63%	14	42
Mixed-use (single assets & portfolios)	£0.20	-84%	-90%	5.86%	-148	-6
All Property	**£9.78**	-18%	-45%	5.64%	15	-5

Source: LSH Research, Property Data, Property Archive

Regional focus

There is a clear geographical emphasis to the recent slowing in activity. Investment in single assets within the regions has been resilient, with the main drag on Q2 volume stemming from subdued investment in London and portfolios.

SUBDUED ACTIVITY IN LONDON CONTINUES

Despite the rebound in office activity, Greater London volume slipped to £4.3bn, down 9% on Q1 and the lowest since Q4 2012. Notably, Central London saw only six deals in excess of £100m, half that of Q1 and the lowest in three years. London's largest deal was ENPAM's £382m (4.00% NIY) acquisition of a 50% stake in Principal Place, EC2, pre-let to Amazon.

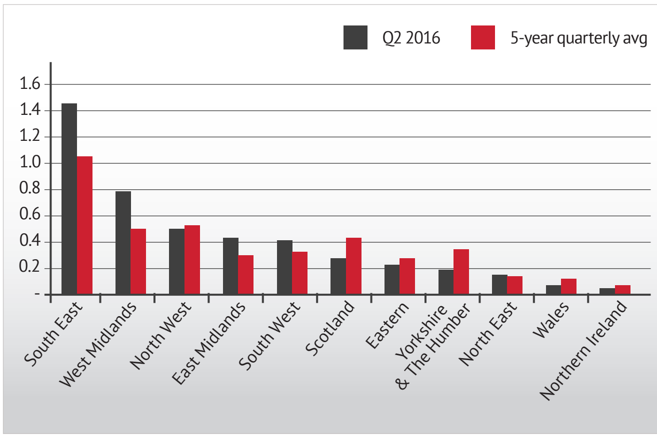
With £800m of assets changing hands, retail was the only sector to see above average volume in the capital. The headline deal was Swiss-based Richemont's £210m (2.75% NIY) purchase of 50 New Bond Street, W1 from Aberdeen Asset Management.

REGIONAL VOLUME HOLDS UP WELL

In contrast with London, investment in the regions has remained robust in the first half of 2016. Collectively, the regions saw volume of £4.4bn, up 17% on the same period last year and 10% above the five-year quarterly average. Regional volume accounted for 45% of the Q2 total, its highest share in over five years.

This was however boosted by two substantial transactions, which together accounted for almost a quarter of the total. These were Mapletree's purchase of Green Park, Reading, the largest deal outside London since Q2 2014, and Intu's £410m (5.20% NIY) acquisition of a 50% stake in Merry Hill shopping centre, Dudley from Queensland Investment Corporation. The latter deal propelled volume in the West Midlands to £0.8bn, 58% above the average.

REGIONAL INVESTMENT VOLUME (£BN)



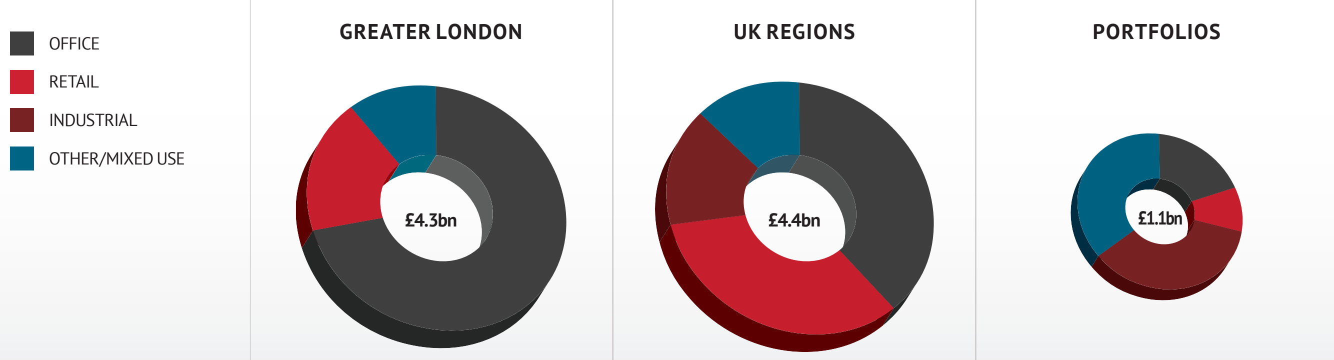
Source: LSH Research, Property Data, Property Archive

A QUIET QUARTER FOR PORTFOLIOS

£1.1bn worth of portfolios changed hands in Q2, a substantial reduction from Q1's £2.6bn and 60% below the five-year quarterly average. Indeed, had portfolio volume been in line with its average, total Q2 volume would have been only 3% down on the previous quarter.

The spike in portfolio activity seen during 2015 was dominated by major deals in the alternative sectors, principally student accommodation and hotels. By contrast, the largest portfolio deal in Q2 was Malaysian Employees Provident Fund's £200m acquisition of Project Phoenix.

LONDON AND REGIONAL BREAKDOWN (£BN)



	GREATER LONDON	UK REGIONS	PORTFOLIOS
VS Q1 2016	-9%	-3%	-59%
VS Q2 2015	-40%	17%	-84%
VS 5YR QTY AVG	-23%	10%	-60%

Source: LSH Research, Property Data, Property Archive

Buyers and sellers

While all categories of investor have become less acquisitive compared with a year ago, the main theme in Q2 was the retreat of the institutions, as overseas investors and quoted property companies continued to buy into UK property.

INSTITUTIONS START SELLING OUT

Having poured into UK commercial property during 2014/15, the institutions have emerged as the main net seller in the market. Institutional buying amounted to £1.5bn in Q2, its lowest level since Q3 2012 and significantly outweighed by £2.5bn of disposals in the quarter. Central London offices drove the £1.0bn divested in Q2, as institutions sold £1.2bn worth of this asset class, including four properties over £100m.

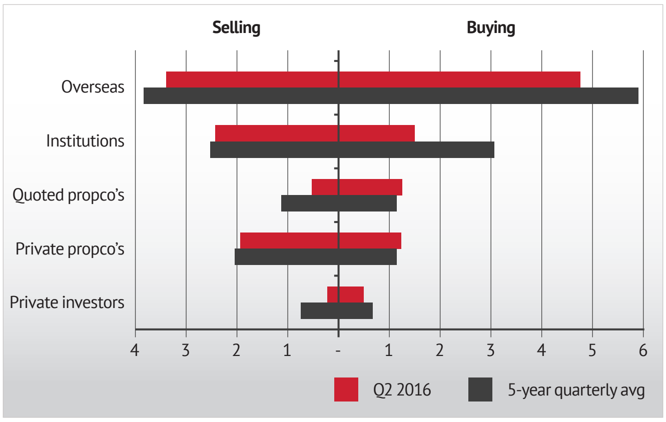
The reversal of institutional behaviour is partly driven by a desire to crystallise strong price growth since 2013. However, this was exacerbated by market uncertainty in the run-up to the Referendum, especially among the retail funds. Aberdeen Asset Management was the largest net seller of UK property in Q2, at £373m, while LaSalle Investment Management was the largest net buyer at only £125m.

OVERSEAS REMAIN LARGEST NET INVESTOR

Despite a continuation of relatively subdued investment from overseas buyers - at least compared with 2015 - they remain the largest net buyers of UK property. Q2's overseas volume of £4.8bn was 19% below the five-year quarterly average, although their net investment of £1.3bn was 35% below average.

In complete contrast with 2015, North American investors were virtually absent from the buyer pool in Q2, acquiring only £0.3bn worth of assets across less than ten deals with net sales

VOLUME BY INVESTOR TYPE (£BN)



Source: LSH Research, Property Data, Property Archive

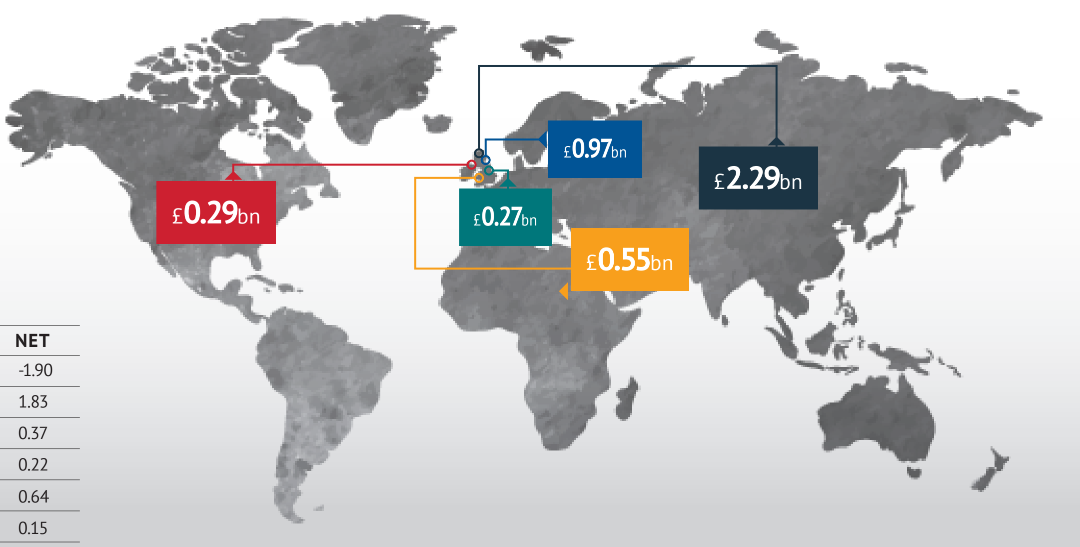
amounting to £1.9bn. The Far East has returned as the dominant overseas source of investment, with net investment of £1.8bn, a figure boosted by Mapletree's purchase of Green Park.

QUOTED COMPANIES REMAIN ACTIVE

Despite the financial market volatility seen after the Referendum, quoted property companies were relatively active in the run-up to the vote. Quoted property companies purchased £1.1bn worth of assets in Q2, 9% above the five-year quarterly average, and were net buyers to the tune of £0.7bn. Intu's £410m (5.20% NIY) acquisition of a 50% stake in Merry Hill, Dudley was by a distance Q2's largest purchase among quoted property companies.

Private companies continue to be net sellers for the twentieth quarter running, divesting £0.7bn in Q2. However, of the £1.2bn of purchases they made, the largest deal was The Arora Group's £100m acquisition of a 50% stake in the InterContinental hotel at The O2 in London from Queensgate Investments.

Q2 2016: GLOBAL INVESTMENT FLOWS INTO UK (£BN)



ORIGIN	£BN	NET
North America	0.29	-1.90
Far East	2.29	1.83
Middle East	0.55	0.37
Germany	0.27	0.22
Europe	0.97	0.64
Other	0.39	0.15

Source: LSH Research, Property Data, Property Archive

OUTLOOK

A little over a month since the historic decision to leave the European Union, increasing clarity is emerging over the near-term consequences for the UK economy and commercial property markets. While the longer term economic outlook is uncertain, UK property is on a much surer footing now than it was in the global credit crunch in 2008.

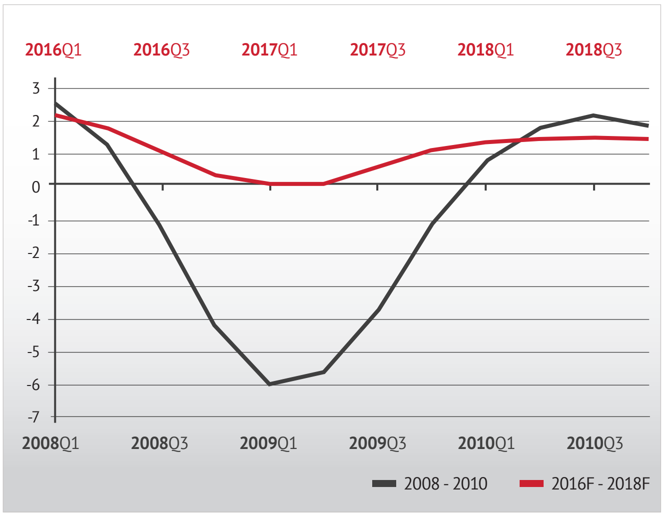
Politically, some order has been already restored in the wake of June's Referendum with Teresa May's rapid appointment to Prime Minister. While it came in chaotic fashion, months of potential uncertainty over the government's leadership has been averted, allowing informal Brexit discussions to begin in earnest.

NEAR-TERM ECONOMIC EXPECTATIONS

Brexit uncertainty will hit growth. At 0.6%, the first estimate of Q2 GDP growth suggests the UK economy belied the negativity seen in the lead-up to the Referendum. However, Markit's July PMI survey on business expectations - the first key piece of data to emerge post-Referendum – revealed its sharpest month-on-month fall since 2009. While the evidence suggests uncertainty will curtail near-term growth, the downward revisions made to the leading economists' UK forecasts come nowhere near to the severe economic downturn in 2008, at their worst amounting to a technical recession.

Fresh monetary stimulus is widely anticipated. To assuage a deeper economic malaise, the Monetary Policy Committee is expected to announce stimulus measures in its August meeting (having opted to preserve the status quo in July). Indeed, the recent rally of UK-listed stocks has largely hinged on this expectation. What form the stimulus takes remains to be seen, although an extension of quantitative easing is widely expected.

UK GDP GROWTH: CREDIT CRUNCH VS FORECAST (%)



Source: Experian, ONS

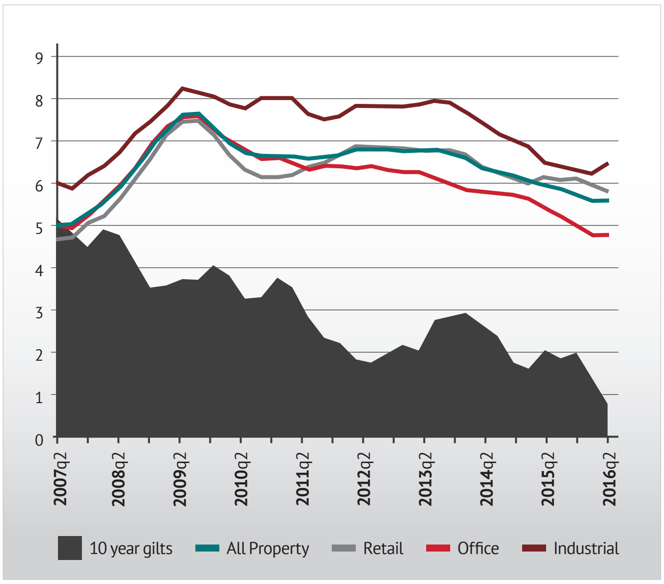
Inflationary pressures to build. Following almost two years of near-zero growth, the sharp slide in the value of sterling in the wake of the Referendum means inflation is set to rise steadily over the coming 12 months, breaking through the 2% official target level and dampening real wage growth in the process.

CONSEQUENCES FOR PROPERTY INVESTMENT

Volume will be down, but certainly not out. Heightened investor uncertainty arising from the leave vote will lead to a continuation of relatively subdued volume over the remainder of 2016, but this will be nothing like the severe market impasse of 2008 / 2009. Indeed, the majority of 'Brexit clauses' enacted in the wake of the vote have prompted renegotiations on price, as opposed to complete withdrawal from deals.

Crucially, unlike the global market crash of a decade ago, the recent boom in commercial property has been fuelled by equity as opposed to over-leveraged debt. With a substantial weight of international capital continuing to seek yield, UK property will remain attractive, albeit at a price that reflects the weakened growth outlook.

ROLLING ANNUAL TRANSACTIONAL YIELD & 10-YEAR GOVERNMENT BONDS (%)



Source: LSH Research, FT.com

Change to the buyer profile. The temporary withdrawal of the UK retail funds from the buyer pool will not by itself have a negative impact on volume. Their need to raise cash may actually support activity and prompt new entrants to the market, particularly overseas investors who can offset the risks around Brexit against their increased buying power resulting from sterling's depreciation.

Price fall will be sharp but short-lived. In the wake of the leave vote, we forecast All Property capital values to fall by 11% in 2016, with the overall correction largely contained within the remainder of 2016. The substantial margin between 'risk-free' government bonds and average property yields (now at circa 480bps) is unlikely to change given the prevailing economic environment, mitigating against a more severe or protracted correction.

The impact on prices will vary. Values will hold up well for prime and secure long-income stock, reflecting the ongoing weight of global capital and a flight to quality seen in the wake of the vote. By contrast, secondary assets – particularly those regarded as being exposed to the negative economic consequences of Brexit on the occupier markets – are expected to see a sharper or more sustained correction.

CONSEQUENCES FOR OCCUPIER MARKETS

The press has highlighted countless examples of prominent deals, emphasising the resilience of the occupier markets post-Referendum. However, the leave vote's effect on occupier demand and rental values will arguably manifest itself later in the year, as the economic impact of Brexit becomes better understood. While this is uncertain, some sectors are more exposed than others.

Offices

The most exposed office markets to Brexit are widely held to be the City and Docklands, which are vital to the UK's huge trade surplus in financial services with the EU. The potential loss of 'passporting rights', which allow London-based firms to sell into the EU, is one area of concern, albeit its effects are arguably overblown when set against the size, complexity and increasing diversity of the City relative to its European rivals, namely Paris and Frankfurt.

Retail, hotels and leisure

If consumer confidence becomes adversely affected as a result of Brexit, it will accelerate the structural obsolescence being seen at the weaker end of the high street retail sector. On the plus side, should sterling's recent depreciation be sustained, increased overseas tourism will bring extra revenue for London's retail and hotel sectors, while at the same time encouraging more domestic spending nationwide as foreign excursions become more costly.

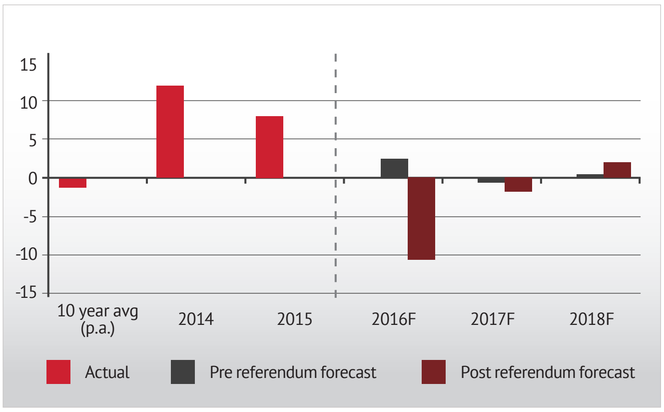
Distribution

The distribution sector is expected to be relatively resilient to Brexit. Occupier demand continues to be underpinned by the steady rise in ecommerce, while tight supply in the sector will support rental levels even if occupier demand is dented. That said, investors should be mindful of the increasingly pan European nature of the logistics sector, and the potential that the terms of Brexit could impact on decisions to locate in the UK.

Manufacturing

If the government seeks to clamp down on the free movement of people, major manufacturers may fear that the UK will jeopardise its access to the single market. While there appears to be little risk that existing operations will be transferred overseas, the prospect of export tariffs could count against the UK with regard to future inward investment decisions. On the upside, if sterling's marked recent depreciation is sustained, the competiveness of domestic manufacturers will be boosted, as was the case when the UK left the ERM in the early 1990s.

ALL PROPERTY CAPITAL VALUE FORECAST (%)



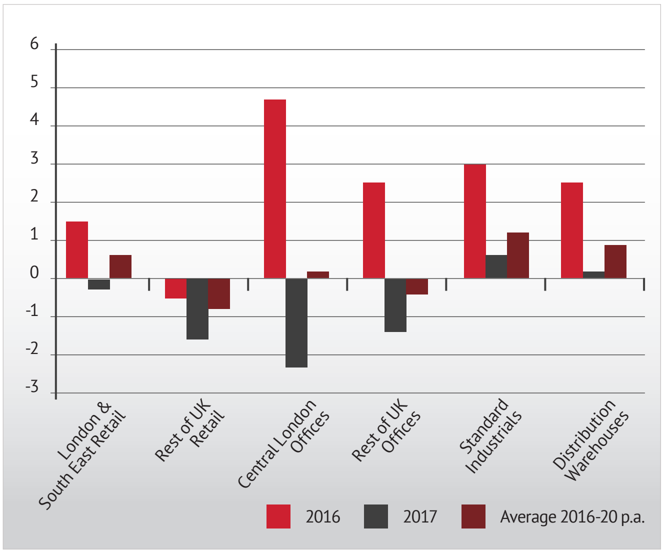
Source: MSCI, LSH, REALFOR

ARE WE HEADED FOR 'BREXIT-LITE'?

Despite the above considerations, an understanding of how Brexit will really play out can only start to form once the Government triggers Article 50 of the EU Treaty, thereby marking the start of formal negotiations over the UK's exit from the EU. There is no set date for this as yet, although the Government has indicated it could be in the New Year.

As a campaigner to remain within the EU, the new Prime Minister's stance is expected to be around a 'Brexit-lite' arrangement, meaning limited controls over the free movement of people in order to retain access to the single market. If the rest of Europe is accommodative rather than punitive, there is a good prospect that the UK economy and property markets will have a bright future outside of the EU.

RENTAL GROWTH FORECAST (%)



Source: LSH, REALFOR

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