UBS

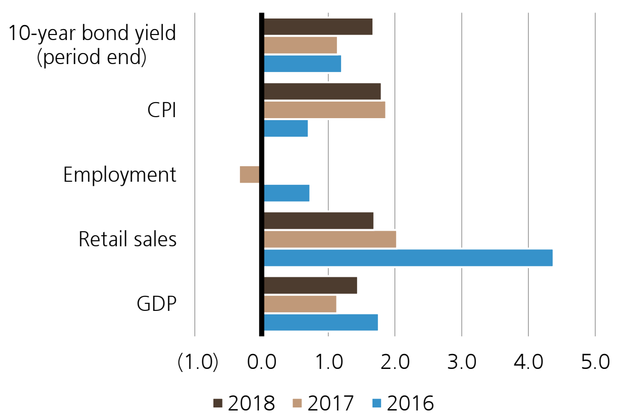
August 2016

UK Real Estate Outlook.

2H16

Economic environment and expected occupier demand
Expectations for UK economic growth underwent some fairly significant downward revisions prior to the EU Referendum, and these have now been revised downwards again, although we do not envision the UK entering a recession as the main scenario. GDP for 2Q16 came in at 0.6%, a stronger outcome than many had predicted; however, it is expected to achieve just 1.8% this year before dropping back further. The weaker outlook for growth in the UK is being largely driven by weakened manufacturing and business activity in the wake of uncertainty about the terms of the UK's separation from the EU, as well as reduced consumer spending on the basis of an expected downturn in activity.

Key economic indicators



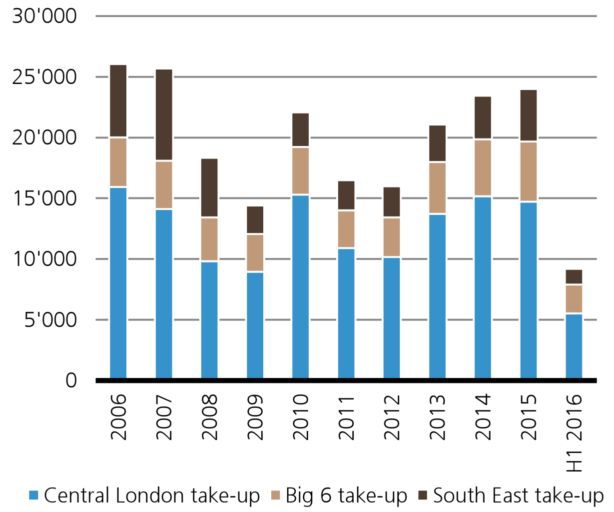
Source: Oxford economics, August 2016

The UK economy has undergone a period of some turbulence following the vote to leave the European Union at the end of the second quarter. There are several signs that things are settling, however: while sterling remains weak, most equity indices seem to have recovered with the FTSE 100 and FTSE 250 now actually above their pre-referendum levels. UK government bond yields have fallen to record lows and remain below 1%, making a rising bond yield driven correction in property markets unlikely in the short term. That being said, there appear to be storm clouds on the horizon with PMI survey readings for July falling at their sharpest rate for seven years, while consumer confidence surveys have been overwhelmingly negative. This prompted an early response from the MPC and and in line with expectations the committee cut the base rate by 25 basis points (bps) and announced a further GBP16 billion in quantitative easing.

Uncertainty in the run up to the EU Referendum weighed on occupier activity in London in 1H16, with larger corporates opting to delay relocation activity until after the outcome of the vote was known and take-up falling by 22% on the level in 1H15. With uncertainty now set to continue in the aftermath of the decision to exit, we expect to see demand levels in London fall substantially as firms delay expansionary decisions until the outcome of the exit vote becomes clearer. This is likely to be particularly apparent among large global corporations from the finance sector who benefit from passporting financial services to the EU market from London. While we do not expect these occupiers to simply vacate the city, they are certainly expected to wait and see how the outcome of negotiations before committing to any major real estate commitments in London with such uncertainty over the future. Small and medium sized domestic companies are expected to be less impacted and may continue to relocate; however, the weaker economic outlook is still likely to impact future expansionary growth.

The larger "Big 6" regional markets[1] may see demand hold up slightly better as they are predominantly driven by domestic companies, and indeed take-up in the run up to the referendum only marginally (2%) lower than 1H15 suggesting that companies outside of London were less concerned about taking on new real estate commitments with the risk of a Brexit scenario. However, regional markets are typically more exposed to a slowdown in economic growth in the UK, particularly outside of core segment of the market where occupational markets require a very high level of economic growth to stimulate sufficient occupational demand to drive positive net absorption.

Annual office take-up
('000 sq ft)



Source: CBRE Erix 2Q16

[1] Big 6 regional markets refers to Birmingham, Bristol, Edinburgh, Glasgow, Manchester and Leeds

On a macro level, the retail story has changed somewhat in 1H16, particularly following the 23 June. Unfortunately it is too soon to accurately assess the impact of the vote in the absence of hard data, thus we have to rely on survey data to use as a proxy. The survey data so far suggests to consumer confidence has been dented, albeit from fairly elevated levels from a historical perspective. Weaker economic growth, higher inflation and a weaker jobs market are likely to follow over the next few years and thus retail spending is expected to reduce from the highs of recent years (2014 and 2015). UK retail sales growth is forecast to correct from 4.5% and 4.1% in 2014 and 2015 to more moderate levels of 2.0% in 2017 and 1.7% in 2018. However, the split between the growth of store based and online sales growth is likely to be quite different, with the expectation of continued acceleration in online sales growth and negative in-store sales growth. The impact of this trend is likely to be a polarisation of retail demand, meaning only dominant retail locations within their catchment area are likely to see significant retailer demand for units and future rental growth. Smaller, non-dominant locations are expected to suffer. Retailers continue to streamline their store networks by focusing on the most profitable and accessible locations, while also relying on their online distribution channel to continue to achieve nationwide coverage.

The outlook for logistics demand continues to strengthen as ecommerce continues to gain market share of the retail trade. The UK already has one of the highest penetration rates for online retail and that is forecast to continue in 2016 with pure play operators, retailers and 3PLs looking to optimise their distribution networks as well as increasing cost efficiencies so as to minimise the impact on their own margins and charges passed on to the consumer. A key transition in recent years has seen an increasing amount of retailers move from 2PLs; i.e. companies hired to deliver individual parcels to 3PLs or 4PLs[1] (companies that operate whole sections, if not all, of the distribution network). This has inevitably lead to more requirements for well-located modern stock which is driving demand for the best quality assets, particularly larger format units in the key locations which, with a limited supply has meant design and build solutions remain the favoured method of satisfying requirements. There is also strong demand for the other of the scale in terms of size formats, with small units in multi-let industrial parks proving very popular. Such schemes, particularly those with good transport connections near large conurbations are particularly in demand as last mile parcel fulfilment centres as well as important locations for trade suppliers. This segment of the market also suffers from land constraints; however, as there is strong competition for higher value land uses, particularly for sites in very close proximity to major cities.

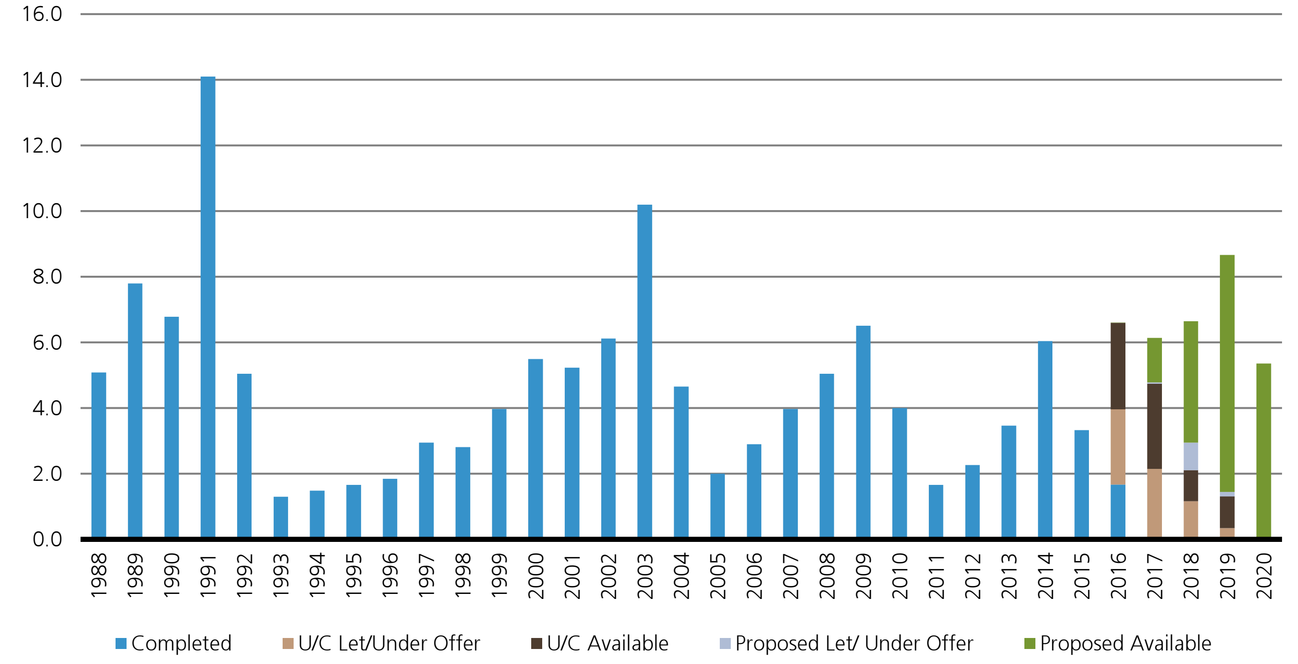
Supply and income growth expectations

The expected slowdown in occupational demand in Central London is set to coincide with a reasonable strong speculative supply response coming through, with ca. 2.6 million sq ft currently under construction speculatively due to complete second half of 2016 and a similar volume in 2017. Even before the Brexit vote, we had seen the increase in speculative supply start to outweigh the strong levels of demand, with availability starting to tick-up since mid-2015 to 6% from 4.4%. With large scale demand in particular set to fall back, we envisage much sharper increases in vacancy over the next 18 months as the new supply comes through to the market. Under our main scenario we expect to see this trigger a rental decline of around 5.3% in the City and West End this year, and a sharper 10% in the City and 8% in the West End in 2017. We do, however, expect that as new speculative supply is likely to be cut-off in the post-Brexit era until confidence is regained, there will be very few schemes completing in 2018/19 by which point the occupational market may be starting to strengthen. However, should we enter the recessionary scenario this turning point will be somewhat further away.

[1] 2,3 and 4PLs refer to second, third and fourth party logistics operators

Central London supply pipeline

(million sq ft)



Source: CBRE Erix 2Q16

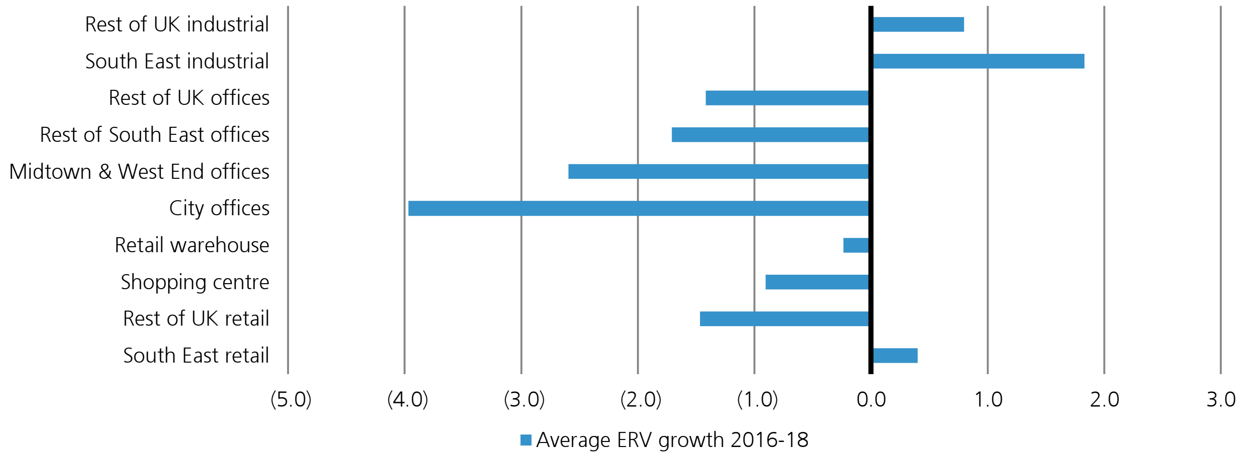
Outside of London there has been a much weaker supply response, which should be help support rents in the regions. However, overall vacancy rates in some of these markets remain very high and are generally comprised of low quality space, some of which was vacated during the previous financial crisis and has not been reabsorbed. While low development levels have kept the supply of prime space at a low level and generated prime rental growth, the overall market has lagged behind somewhat due to the oversupply of secondary. With a similar trend set to continue of low development and low demand, we expect rental levels for core, well located assets in the main regional markets to maintain rents far better than the secondary market, which would be particularly exposed to a recession scenario as occupiers would again downsize and vacate more secondary space back onto the already saturated market.

Historically there has been a close correlation between retail sales growth and retail ERV growth; however, in this cycle we have seen a growing disconnect with retail sales growth exceeding 4% in 2014 and 2015, while retail ERVs have remained effectively flat outside of the South East. We believe that the fundamental changes in consumer behaviour have disconnected this relationship as a large proportion of the growth in retail sales have come through the online channel rather than through physical stores. Vacancy rates remain very high in many parts of the country, particularly for smaller, less dominant town centres. These more secondary centres are likely to be under increasing levels of pressure over the coming years with retail sales growth moderating over the five-year forecast period. Essentially, the number of physical stores required in the UK has reduced in recent years due to wider structural changes occurring in the retail sector, and this will continue to hold back overall rental growth prospects for the sector until some of the secondary/ tertiary properties are removed from the segment through change of use or redevelopment.

There are, however, pockets where vacancy rates are much lower and rental growth prospects are more positive. Of the segments, retail warehousing has by some way the lowest national vacancy rate of 6% compared to 13.5% for shopping centres and 11.3% for high streets. Geographically speaking, London and the South East typically have much lower vacancy rates across all segments, supported by strong population growth in London, relative affluence and desire for convenience, which is particularly supportive of commuter town centres. Outside of London and the South East, historic towns and cities – particularly those popular with tourists – continue to have strong prospects for rental growth. In addition, dominant schemes in and around the key regional centres will continue to perform well.

Availability of logistics units continues to trend down in the UK despite an increase in completions. Speculative development and completions have increased over the past couple of years with 3.5 million sq ft coming to the market in 1H16; however, they have not reached anything like pre-recession levels and there are already signs of caution creeping back into the market. Despite very high demand, just 11 speculative schemes over 100,000 sq ft were announced in 2016 compared with 47 in 2015. This is partly due to rising land costs and strong competition from alternative uses in some locations restricting the scope for industrial development, as well as the capacity to deliver turnkey schemes very quickly which can satisfy non-urgent occupier demand without having to take on riskier speculative schemes. These is reflected by the predominance of BTS activity in this sector, with design and build space still accounting for well over 50% of take up in the first half of 2016. For these reasons we do not envisage a supply response which could not be absorbed by occupier demand and have a negative impact on rental values over the forecast period.

Annual average ERV growth forecasts
(2016-18)

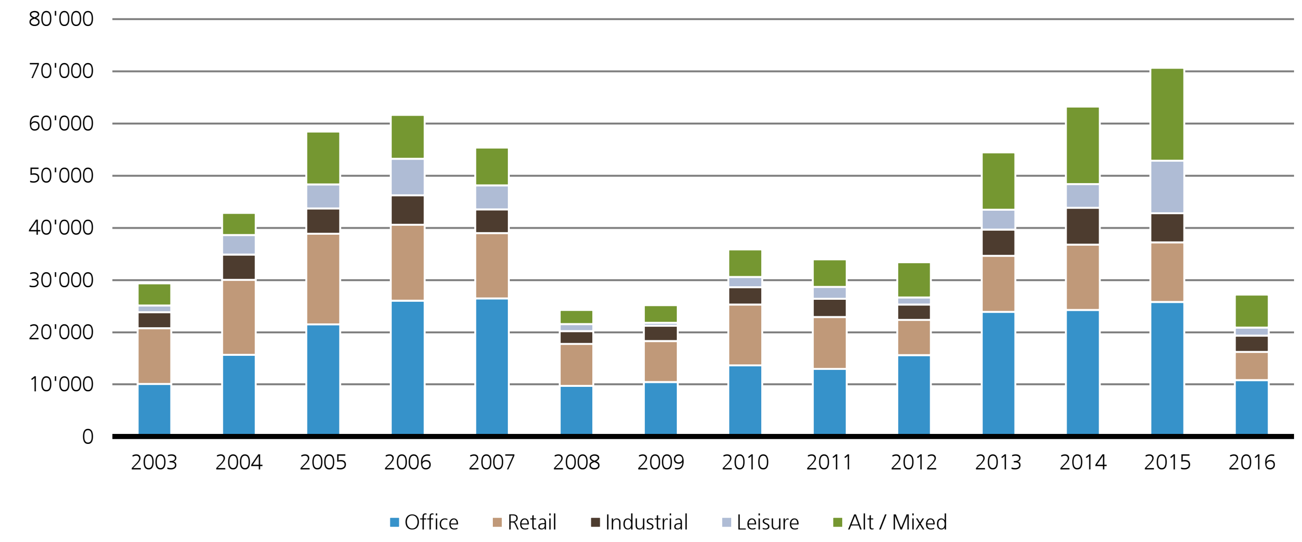


Source: UBS Asset Management, Global Real Estate Research & Strategy, August 2016

Capital markets
The first half of 2016 saw a slight tapering off in investment activity, which was expected considering the high volumes and strong yield compression of the previous few years with the majority of sectors comfortably below their pre-crisis peaks. Added to this are high levels of investor uncertainty in the run up to the referendum and considering the surprise outcome, we would expect the third and fourth quarter to be muted also. That being said, volumes totaling around GBP 25.5 billion were still comfortably above the long-run average and foreign investment, which many thought would decline, was actually fairly robust in the second quarter, while capital expended by UK institutions fell away by around 50%, particularly in Central London where pricing is considered to be particularly keen.

In the wake of the referendum, there were signs that the Central London market could be correcting with various retail funds being forced into quick sales at discounts of around 50 bps. Such funds make up less than 5% of the total market, however, and the dust appears to have settled, with a consensus that sales undertaken with less urgency would not trade at such a discount. In the wake of the referendum, there have also been increased enquiries from overseas investors looking to take advantage of currency movements, which further reduces the likelihood of a rapid out movement in pricing. Moreover, the result of the referendum triggered a flight to safety among investors pushing UK gilt yields to below 1%. In light of this, it seems unlikely there will be significant outward movements in yields, as investors selling property assets may well struggle to reallocate with government bond yields at record lows and equity markets highly volatile. The lower for longer interest rate environment and cheap cost of debt is likely to be supportive of real estate pricing as well.

UK investment volumes
(GBP '000)



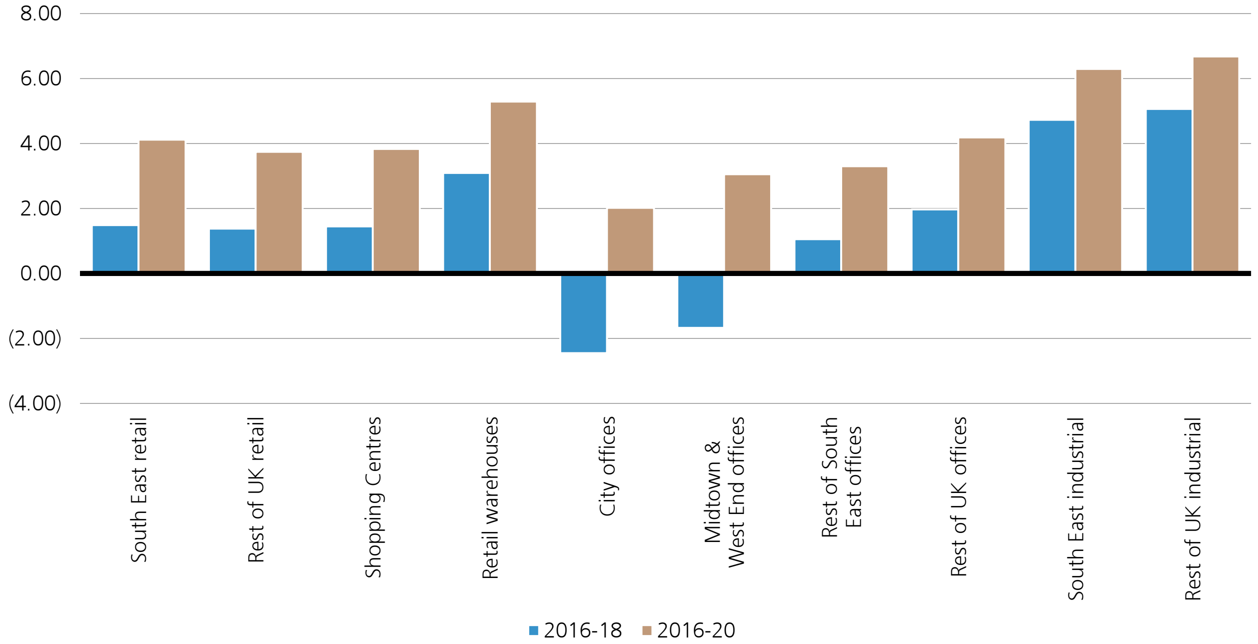
Source: Property Data August 2016

Office market outlook
Due to the uncertainty created by the Brexit vote, weaker economic outlook and softer investor sentiment, we are expecting capital returns for all office segments to turn negative between 2016-18. Central London is expected to have the most severe correction as yields move out from an already very low base and the market is facing a short-term over supply concern impacting rental expectations. However, we do expect that the damage to yields, particularly for core secure income assets in London will be limited by the very low interest rate environment and exceptionally low returns in other core global real estate markets. Under the avoid recession scenario, we see the market recovering by 2019 as the economy and rental growth outlook should be strengthening at the same time as a likely shortage of new build office space. Outside of London we expect a less severe correction; however, we would highlight concerns – particularly in secondary locations and poorer quality assets – that the weaker economic outlook will severely dent occupational demand. The low levels of development outside of London should be supportive of rental values for prime central assets; however, there remains a significant oversupply of secondary space which will now be adversely impacted by the weaker outlook for economic growth.

Retail market outlook
We maintain a weak outlook for the retail sector overall as the continuing evolution in consumer behaviour will place further pressure on the already weak occupier markets outside of the dominant locations. As the current rate of retail sales growth is failing to drive significant ERV growth for the sector, we do not expect this to change going forward especially as the rate of sales growth is likely to fall back rather than increase. In terms of segments we can, however, be more positive about retail warehousing given its relatively defensive high income component, which will be supportive of returns in a negative capital growth environment. Relatively speaking, the stronger market fundamentals of the South East should be more supportive of ERV levels even though entry yields are very sharp for good quality assets. We are cautious on shopping centres, especially those in more secondary locations, and rest of UK retail unit shops are expected to continue to underperform primarily due to the higher component of secondary and tertiary space in these segments.

Logistics market outlook
We continue to expect the best total returns over the three and five-year forecast periods to come from the industrial sector. The sector is undergoing a structural shift, which has seen a variety of retail operators now seeking to get a foothold in the distribution sector, either directly by taking big sheds themselves or by contracting 3PL/4PL logistics operators, many of which are expanding to meet this growing demand. This increased competition provides both improved prospects for rental growth over the forecast period as well as ongoing demand for investors keen to gain exposure to this new market sector, although after rapid yield compression in recent years we do envision some level of correction. The sector is expected to benefit from its high income component which supports stronger income returns during the low growth period and provides a larger cushion than other sectors to absorb the narrowing spread with government bond yields when fixed income returns start to rise.

Annual average total returns
(in %)



Source: UBS Asset Management, Global Real Estate Research & Strategy, August 2016

Data sources: Oxford economics, CBRE, PMA, Local Data Company, Property Data, IPD, UBS Asset Management, Global Real Estate Research & Strategy

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