UBS

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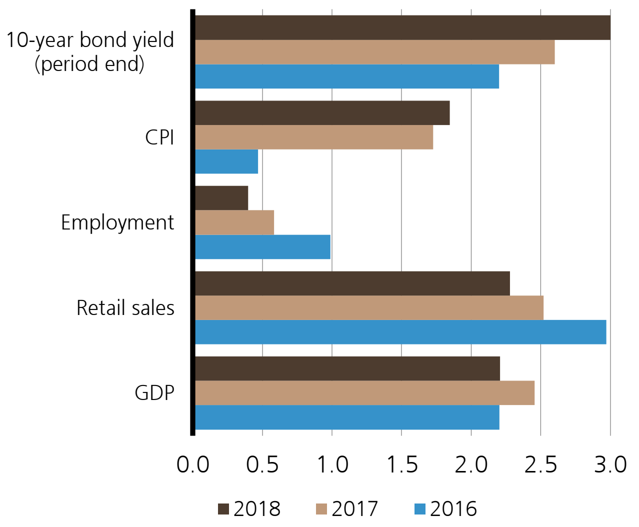
UK Real Estate Outlook.

1H16

Economic environment and expected occupier demand
Expectations for UK economic growth have undergone some fairly significant downward revisions over the past six months. GDP for 2015 came in at 2.2%, someway below the 2.6% expected mid-way through the year, while the expectations for growth in 2016 now stands at 2.2%, down from 2.8%. The weaker outlook for growth in the UK is being largely driven by external factors, namely the slowdown in China and emerging markets, increased volatility in global financial markets and growing geo-political uncertainties.

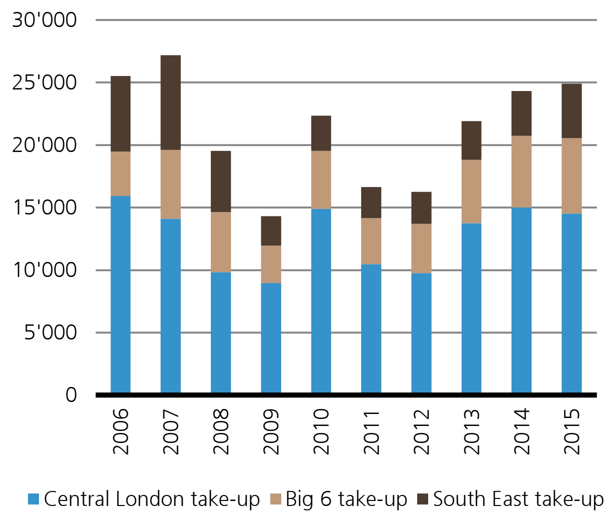
take-up in the "Big 6" regional centers reaching a new record level of six million sq ft. Occupier demand in Central London continues to be very strong and well above the long-term trend and although there was a slight dip back in take-up levels in the second half of 2015 this was from an exceptionally high level. Demand levels remain well above the long-term trend. With employment and population growth in London maintaining a rapid pace, the level of occupier demand is expected to continue to drive positive net absorption of office space.

Key economic indicators



Source: Oxford economics, February 2016

Annual office take-up
('000 sq ft)



Source: CBRE Erix 4Q15

Domestically the economy remains in relatively healthy shape, although the polarization in performance between the dominant services sector and the rest of the economy has been accentuated. Manufacturing and exports in particular are having a very tough time, initially squeezed by the appreciation of sterling against the euro, and now coming under pressure from the drop in demand for exported goods from emerging economies. And while the UK has a relatively low exposure to global commodity markets, the few remaining producers have come under severe competitive pressure, with several high profile sites being forced to cease operations.

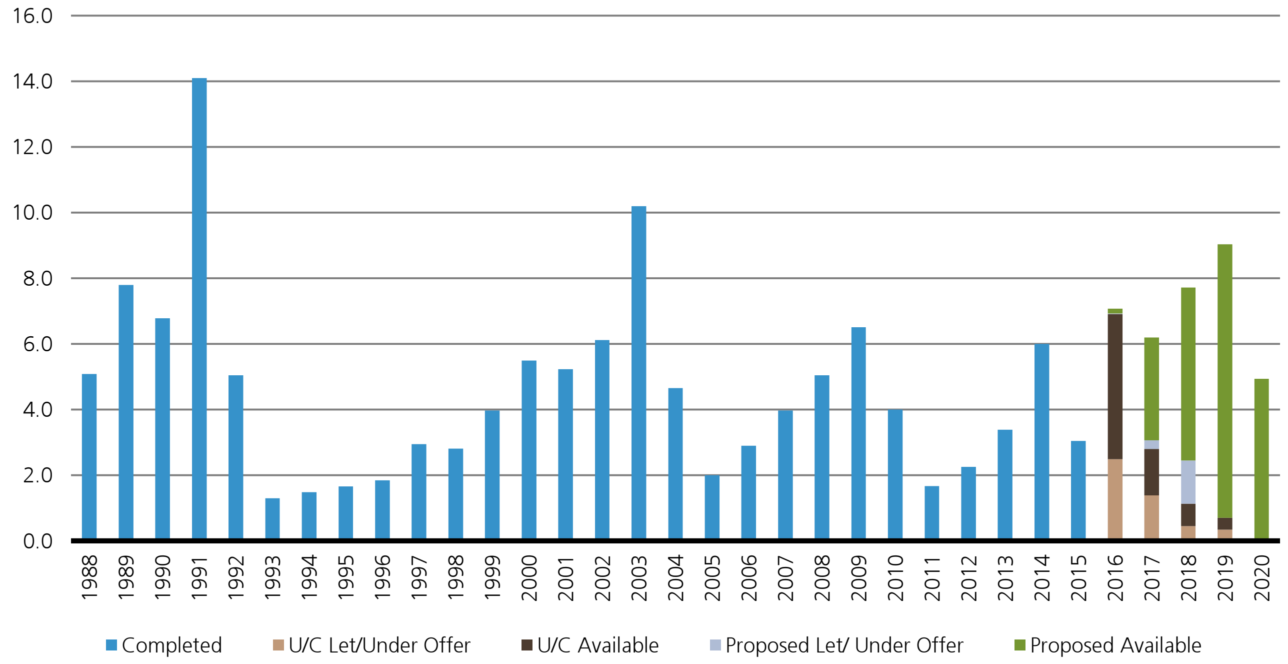
However, manufacturing accounts for only a relatively small (ca. 9%) proportion of the UK economy, and supported by the strengthening services sector, overall employment has maintained a robust pace of growth. This has led to a rise in employment by 0.7% in 4Q15, bringing the unemployment rate down to 5.1%, the lowest since 2005. This has been translating into a strong increase in office occupier demand, which has now spread out of London and the South East with

On a macro-level the retail story continues to appear very positive, with consumers continuing to benefit from exceptionally low inflation and a reasonable level of nominal wage growth coming out of the strengthening labor market. And despite a mixed Christmas for retailers – disrupted by an un-seasonally warm winter and aggressive discounting triggered in part by the rise of events such as Black Friday and Cyber Monday – the overall annual retail sales growth for 2015 reached 4.1% per annum. 2016 has started off on a positive note with like-for-like sales in January rising 1.2% demonstrating a clear disconnect between the impact of global slowdown on financial markets and the domestic resilience of UK consumers. But despite the undoubtedly positive fundamentals driving retail sales, the continuing growth of online retailing means that only dominant retail locations within the catchment area are seeing any significant benefits in rising retailer demand for units. 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.

By contrast, the outlook for logistics demand continues to strengthen as consumer behavior continues to shift towards online, while retailers and 3PLs (third-party logistics operators) push for increasingly efficient distribution chains to reduce delivery costs and improve the consumer experience. This is driving demand towards the best quality assets in the key logistical locations across the UK, and with a limited supply of available high quality units this has driven a rapid increase for design and build units which now account for around two thirds of new logistics take-up. Strong demand is also being recorded at the smaller end of the scale in multi-let industrial parks within or close to major urban conurbations to service the final part of the logistics chain. Again, demand is focused towards better quality space in these locations; however, with a shortage of supply and strong competition from higher value land uses, occupiers also have to consider design and build options to meet their requirements.

Supply and income growth expectations
Central London continues to be the focus of office development activity; however, there are indications that there may be a delay in the expected supply response which the strong level of occupational demand has been encouraging. Availability ticked up slightly for the first time in eight quarters in the second half of 2015 due to the inclusion of speculative schemes scheduled to complete in 2016; however, even taking these schemes into account availability remains 17% below the 10-year average. It was expected that completion levels would increase in 2017; however, nearly 50% of the speculative element of this proposed space has not yet started. And of the speculative space which is already under construction, virtually all (1.2 million sq ft) is located in the City. We believe that due to the EU referendum, major speculative schemes have been put on hold in London until the outcome is known, and this is supported by construction starts in Central London falling back significantly in the second half of 2015 following the general election result which confirmed that the referendum would take place.

Central London supply pipeline
(million sq ft)



Source: CBRE Erix 4Q15

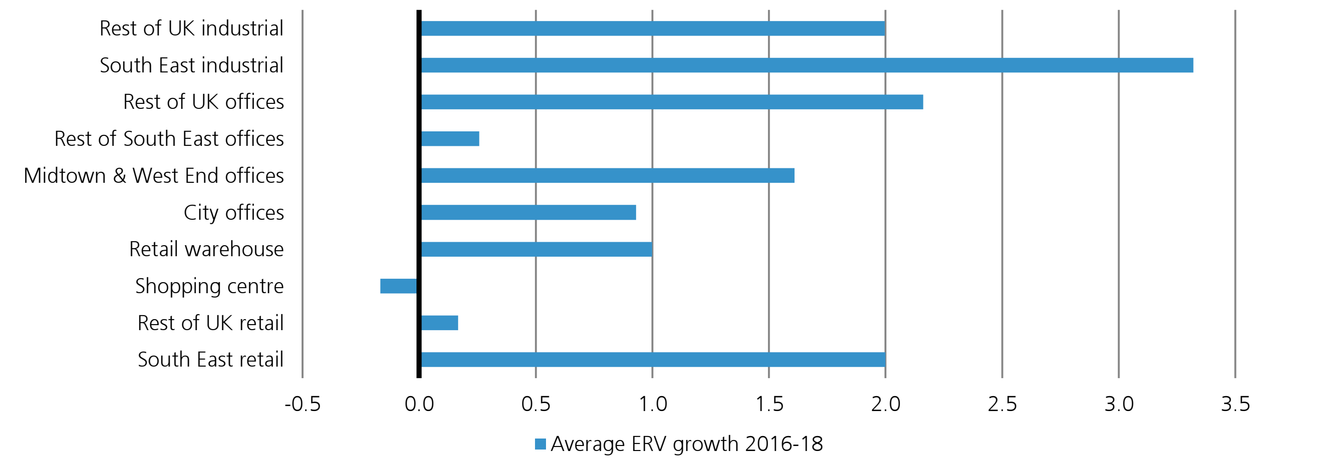
Under the main scenario the UK will vote to remain in the EU on 23 June 2016 and construction starts will rebound again in the second half of 2016. This will shift the bulk of the supply response back to 2018 and beyond, which will have a significant impact on the expected profile of rental growth in Central London. With potentially a very limited amount of speculative space coming through in the West End in 2017, we expected a prolonged period of rental growth as supply continues to fail to catch up with demand. In the City, where there is already a reasonable amount of speculative space under construction for completion in 2017, we believe that the market will remain in the landlords' favor but with easing rental growth pressure. The correction in both markets is expected to come from 2018 onwards when the supply response fully kicks in.

The strengthening economy and improved occupier demand has encouraged more office development to move forward outside of London. Reflecting this improved confidence, a higher proportion of space coming through to the market is now being developed on a speculative basis (61% in 2016 and 82% in 2017). However, overall completion levels will remain well below the previous cycle peak level, and if occupier demand continues in a positive trajectory it should be able to comfortably absorb the new space coming onto the market and maintain upward pressure on rental levels, with 2017 forecast to be the peak of average rental growth at 3.5%.

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 behavior 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. Retail vacancy rates remain very high in many parts of the country, particularly for secondary grade space in non-dominant schemes, and with retail sales growth likely to moderate over the forecast period as inflation gradually returns to normal and erodes disposable income growth, it is hard to see the current trends reversing in a period of lower retail sales growth. Essentially, there are too many physical stores in the UK for the existing structural demand of retailers, and this will continue to hold back overall rental growth prospects for the sector.

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 centers and 11.3% for high streets. Geographically speaking, London and the South East typically have much lower vacancy rates across all segments, supported by the exceptional growth of London's population, relative affluence and desire for convenience (which is particularly supportive of commuter town centers). 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 centers will continue to perform well.
The supply-demand balance in the industrial sector continues to be in the favor of landlords; however, some speculative logistics space has started to come through to the market in the second half of 2015, causing the availability of new/early marketed logistics space to increase by around four million sq ft in the second half of 2015. It remains, however, well below historic levels and at the current levels of demand should be comfortably be absorbed with continuing upward movements in rental values. Despite the exceptionally strong structural demand within the sector, we do not envisage a supply response which would have a negative impact on rental values over the forecast period. 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.

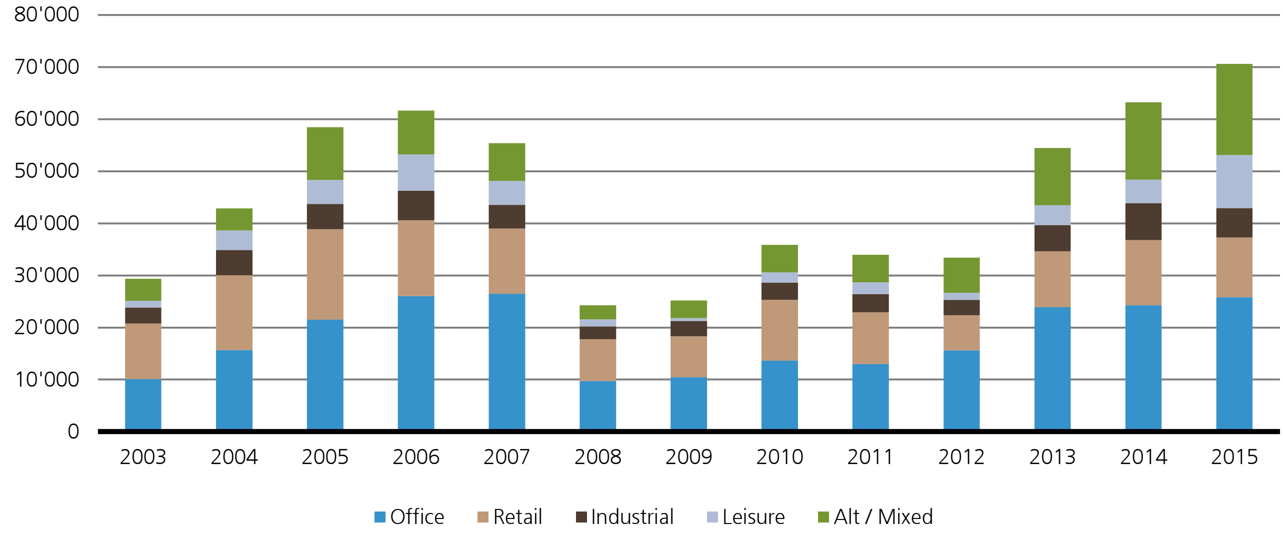
Annual average ERV growth forecasts
(2016-18)



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

Capital markets
A significant amount of capital continues to target UK real estate; however, volumes eased off very slightly in the second half of 2015. Nonetheless, the year reached another record level of investment at GBP 70.6 billion, 50% of which came from foreign buyers, while in Central London this proportion rose to 66%. Investors are, however, becoming increasingly price sensitive in the UK, which is not surprising in a market where yields are either comfortably below or approaching record low levels. One of the notable changes over the past six months has been that, while there is still plenty of interest, the average number of competitive bidders on good quality assets has fallen from 10+ to just three or four.

UK investment volumes
(GBP '000)



Source: Property data February 2016

With the slight easing in investor demand at the current level of pricing, there is not enough competition to drive the yield compression of recent years. However, with the expected rise in UK interest rates continuing to move out, the spread between UK property yields and gilts will remain favorable to property for at least the next 12-18 months, and while this spread remains wide we don't envisage any outward correction in UK property yields at this stage of the cycle. Pricing is set to stabilize at current levels this year, with a correction in pricing coming through in 2018. And while there may be a pause in investment activity in the run-up to the EU referendum, with limited pressure coming through on the sell side we do not expect investors to offer significant discounts to reduce their UK exposure. Rather, we expect that most investors will simply wait and see the outcome of the vote before re-assessing their commitments in the UK, which in the case of an "in" vote shouldn't have any significant implications for pricing.

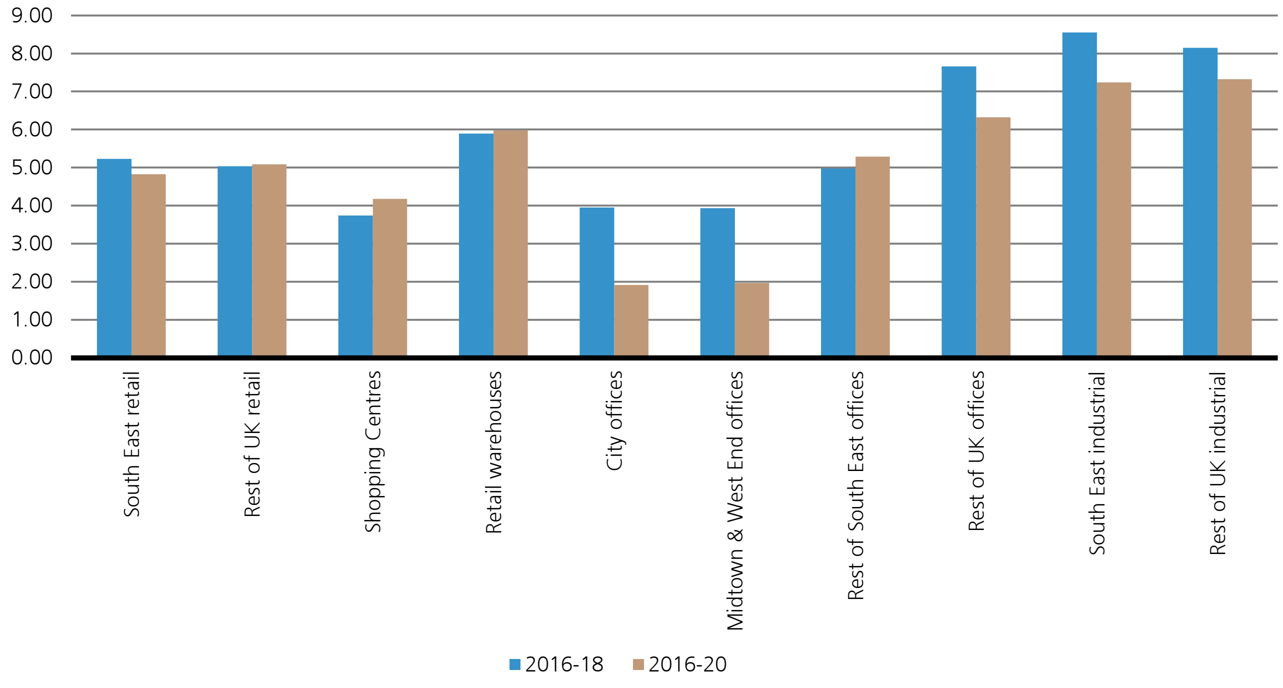
Office market outlook
The slightly delayed correction to capital values should continue to support a reasonable level of returns from City and West End offices in 2017/18. Although we are expecting flat yields, both markets will benefit from the capitalization of 2015's very strong rental growth, with some more moderate rental growth to come through this year providing some additional capital growth in 2017. By 2018, however, we would expect government bond yields to have started to return to a more normalized level, which will make low yielding London property look comparatively expensive and trigger a pricing correction. At the same time we would expect the delayed supply response to be coming through to the market and impacting ERV growth. While office yields outside of London are also expected to see some outward movement, with a higher income return component there is more capacity to absorb the spread in rising bond yields and maintain relative value without undergoing a severe correction. Combined with a more muted supply response in the regions this will drive relative outperformance over Central London over the forecast period.

Retail market outlook
We maintain a weak outlook for the retail sector overall as the continuing evolution in consumer behavior will put 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 low capital growth environment. The more positive occupier fundamentals in the south east should provide some boost to income growth, although this low yielding sector is the most exposed to rising interest rates towards the end of the forecast period. Shopping centers and rest of UK retail 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 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. This sector is also supported by a strong underlying occupier market, with which a supply side restricted by a prominence of pre-let schemes and competition for land should maintain positive rental growth both in the South East and rest of UK throughout our forecast period.

Annual average total returns
(%)



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

Viewpoint
The outlook for the UK real estate market outlined in this report has been compiled under the main economic scenario which sees a steady continuation of economic growth in the UK of between 2-2.5%. While this is currently the main scenario, unfortunately we cannot rule out the potential for a market crash which would impact both the financial and occupier markets. These situations typically come about from a market "shock" and are by definition unpredictable; however, in the current global climate there are several risks – particularly on the geopolitical side – which could trigger this. The largest one facing the UK real estate market is the upcoming EU referendum, which will be held on 23 June 2016. For the purposes of forecasting we have taken the most likely outcome at present, a vote to remain in the EU[1], as the base case. Polls are, however, very tight and it is likely that the

[1] UBS Asset Management, Global Real Estate Research & Strategy, February 2016

result will end up being close either way. It is inherently difficult to forecast exactly what the exact consequences of a Brexit scenario would be for UK real estate, however, we can highlight a few predictions for what might happen in the aftermath and which sectors and geographies would be the most affected.

Firstly it is important to point out that the full implications of a Brexit will not be fully understood for some time after the result, and it is likely to be years rather than months before Britain's position within Europe outside of the EU is finalized. The major consequence of this for real estate markets is uncertainty on both the investment and occupational side, which tends to lead to stagnation in activity. A survey of real estate investors clearly indicates that most (64%) would seek to downsize their existing exposure to the UK market to some degree in the event of a Brexit, and with a further 21% indicating they would be reducing future exposure into the UK, this would inevitably lead to a situation where there was an additional amount of real estate stock coming to the investment market from the downsizers, at the same time as a reduction in the number of buyers which would be targeting it. We would also have to expect some reduction in the flow of capital from buyers not already in the market, who may reconsider their entry into the market, at least until the initial volatility of the situation has died away.

This would have inherently negative implications for pricing across real estate markets, and the most severe would likely be in Central London which has the highest dependency on foreign capital. This capital is typically more footloose than domestic capital and has the option to be redeployed elsewhere. On the occupational side, we would also expect the most severe consequences to be in London; however, the extent of this may be overplayed somewhat by the media. While we would expect some global corporates to reconsider their European strategy in light of a Brexit, which could result in the transfer of some specific functions to alternative locations within the EU, we are not expecting any kind of mass exodus from the City. The vast majority of global corporations in London are committed whether or not the UK is in the EU. Outside of London the more domestically driven occupational markets would in theory be less exposed, but they would be more exposed from an overall slowdown in economic growth and weaker sentiment which comes about as a result of uncertainty in the aftermath of the referendum.

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

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